Sect. 263A: Challenges in Allocating Direct and Indirect Costs
Mastering Regs, Guidance and Rulings and Making Tough Decisions on Costs

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Sect. 263A: Challenges In Allocating Direct And Indirect Costs Webinar

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Today’s Program

Fundamental Concepts Under Sect. 263A
[Jim Martin and Rich Shevak]

Sect. 263A Compliance Challenges
[Kathleen Meade]

Impact Of Recent And Forthcoming Guidance
[Ellen McElroy]

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FUNDAMENTAL CONCEPTS UNDER SECT. 263A
Sect. 263A Capitalization

*General principles of §263A*

- Provides uniform rules for capitalization of costs to:
  - Real and tangible personal property produced, and
  - Real and personal property acquired for resale
- Applies to both inventory and self-constructed assets (i.e., assets produced for sale or use within the taxpayer’s business)
- Generally requires taxpayers to capitalize costs over and above those which are being capitalized for book purposes
Sect. 263A Capitalization (Cont.)

**General applicability**

- Terms broadly defined
  - “Produce” defined to include construct, build, install, manufacture, develop, improve, create, raise or grow and property produced under contract for the taxpayer
  - “Tangible property” defined to include certain creative property (e.g., books, films, sound recordings)
Sect. 263A Capitalization (Cont.)

*Exceptions*

- Inventory valued at FMV
- Small resellers
- R&D costs
- §460 property
- Property provided incident to services
- Other (e.g., timber, qualified creative expenses, not-for-profit, intangible drilling costs, cushion gas, loan origination)
Sect. 263A Capitalization (Cont.)

Overview of calculation

Step 1: Identify costs capitalized for financial accounting

Step 2: Identify “additional” costs required to be capitalized for tax purposes (whether positive or negative)

Step 3: Allocate additional costs between production or capitalizable resale activities, mixed service activities and deductible activities

Step 4: Allocate mixed service costs between production or capitalizable resale activities and deductible activities

Step 5: For inventory, allocate additional §263A costs between ending inventory and cost of goods sold; and, for self-constructed assets, capitalize into basis and depreciate capitalized costs
Sect. 263A Capitalization (Cont.)

Costs required to be capitalized

All direct costs must be capitalized

- Producers: Direct material costs, direct labor costs
- Resellers: Acquisition costs (§1.471-3)

Indirect costs must be capitalized when they directly benefit or are incurred by reason of the performance of production or (capitalizable) resale activities.
Sect. 263A Capitalization (Cont.)

Capitalizable indirect costs:

- Indirect labor
- Officers’ compensation
- Pension & other related costs
- Employee benefits
- Indirect materials
- Purchasing costs
- Handling costs
- Storage costs
- Cost recovery
- Depletion
- Rent
- Taxes (other than income)
- Insurance
- Utilities
- Repairs & maintenance
- Engineering & design costs
- Spoilage
- Tools & equipment
- Quality control
- Bidding costs (successful bids)
- Licensing & franchise costs
- Interest (only if 263A(f) applies)
- Capitalizable service costs
Sect. 263A Capitalization (Cont.)

Costs not capitalized:

- Selling and distribution
- R&D
- Sect. 179 expenses
- Sect. 165 losses
- Cost recovery of idle assets
- Income taxes

- Strike costs
- Warranty costs
- On-site storage costs at a retail store facility
- Unsuccessful bids
- Deductible service costs
Deductible service costs

- Overall management or policy-setting
- Strategic business planning
- General financial accounting
- General financial planning and financial management
- Personnel policy
- Quality control policy
- Safety engineering policy
- Insurance or risk management policy

- Environmental management policy
- General economic analysis and forecasting
- Internal audit
- Shareholder, public and industrial relations
- Tax services
- Marketing, selling or advertising
Mixed service costs

• Service costs partially allocable to production or capitalizable resale activities and partially allocable to deductible activities
  - Accounting
  - Payroll
  - HR
  - IT
  - Legal

• 90-10 de minimis rule (§1.263A-1(g)(4)(ii))
Mixed service costs allocation methods

• Direct reallocation
• Step allocation
• Simplified service cost methods (SSCM)
• Other reasonable methods, such as
  − Headcount
  − Labor hours
Simplified service cost methods

SSCM with production cost allocation ratio =
\[
\frac{\text{§263A production costs}}{\text{total costs}} \times \text{MSC}
\]

SSCM allocation ratio with labor-based allocation ratio =
\[
\frac{\text{§263A labor costs}}{\text{total labor costs}} \times \text{MSC}
\]

* Excluding MSC
** Excluding MSC, income taxes and interest
Sect. 263A Capitalization (Cont.)

Facts and circumstances methods for allocating additional §263A costs

• Burden rate
  – Pre-determined rates used to approximate costs
  – Significant variances must be capitalized to ending inventory

• Standard cost
  - Standard/budgeted costs used to approximate costs
  - Significant variances must be capitalized to ending inventory

• Other reasonable methods
  – Must allocate costs to specific items in inventory (TAM 9717002)
  – Must not be used to circumvent the simplified methods
Sect. 263A Capitalization (Cont.)

*Simplified production method (SPM)*

**Step 1: Compute absorption ratio**

\[
\text{Absorption ratio} = \frac{\text{Additional §263A costs incurred during the year}}{\text{Total §471 Costs incurred during the year}}
\]

**Step 2: Allocate additional §263A costs to ending inventory**

\[
\text{Absorption ratio} \times \text{Ending inventory}
\]
Sect. 263A Capitalization (Cont.)

*Simplified resale method (SRM)*

**Step 1: Compute absorption ratios**

- **Purchasing costs ratio**
  \[
  \text{Purchasing costs ratio} = \frac{\text{Purchasing costs incurred during the year}}{\text{Purchases}}
  \]

- **Storage and handling costs ratio**
  \[
  \text{Storage and handling costs ratio} = \frac{\text{S&H costs incurred during the year}}{\text{Beginning inventory} + \text{Purchases}}
  \]

**Step 2: Compute combined absorption ratio**

\[
\text{Purchasing costs ratio} + \text{S&H costs ratio} = \text{Combined absorption ratio}
\]

**Step 3: Allocate additional §263A costs to ending inventory**

\[
\text{Combined absorption ratio} \times \text{Ending inventory}
\]
Sect. 263A Capitalization (Cont.)

Simplified resale method (SRM)

- More favorable than SPM, because denominator of storage and handling ratio is diluted by beginning inventory
- Available to resellers and resellers with de minimis production activities
  - Might not be available to some “resellers” because of broad definition/interpretation of “produce”
Kathleen Meade, BDO USA

SECT. 263A COMPLIANCE CHALLENGES
UNICAP - Why Now?

- Many UNICAP calculations have not been reviewed recently and are no longer compliant and/or optimal.

- IRS scrutiny has increased significantly
  - Tier 1 (mixed service costs)
  - Sales-based royalties
  - Negative adjustments
UNICAP - What To Look For

• Absorption ratio high/low
  - Caveat: What’s capitalized to book inventory?
  - Focus: High-dollar allocable costs
    • Execs/engineers, warehouse, rent, depreciation
    • Allocation approach: By department (vs. by cost categories such as labor, occupancy, OH)

• Duplicate/omitted costs
  - Sources: “Super-full absorption”, FAS 151, IT system changes
    • Review FS footnotes and audit workpapers!
    • Watch: “De facto” method changes - 3115 required
UNICAP - What to Look For (Cont.)

- Simplifying elections
  - Historic absorption ratio election (“HAR”)

- Mixed service costs: Simplified service cost method (labor ratio)
  - Key: Taxpayer has significant deductible labor costs
  - Retailers, high-tech manufacturers, distributors with large field service operations
  - Contract labor: Watch PLR 9247005

- Mixed service costs: 90/10 rule
  - Executives, engineers (R&D, field service)

- Purchasing labor costs: 1/3, 2/3 rule
UNICAP - What To Look For (Cont.)

• Simplified UNICAP method formulas
  - Producer vs. reseller classification (reseller usually more favorable)
    • Watch private label goods (reseller re-classed as producer)
      - GAP (private label only) vs. CVS (multiple brands)
  - “De minimis” production rules (retain reseller eligibility)
    • Grocery chains (bakery, private label production), distributors (heavy equipment, textiles/home furnishings)
  - “Modified simplified” method impermissible
    • PLR 200144003, PLR 9717002
  - Consider change to multiple burden rate method
    • Sales-based royalties, significant “unprocessed” inventory
UNICAP - Common Errors

- No UNICAP costs capitalized (risk)
  - Outgrew exemption limits, GAAP stopped capitalizing costs

- “Frozen” absorption or allocation ratios used (risk/opp)

- Purchases/production costs issues (denominator)
  - Risk: Non-inventory costs included (freight-out, shipping)
  - Opportunity: Use gross purchases (e.g., vendor return credits)

- Ending inventory issues (multiplicand)
  - Risk: Non-deductible reserves not added-back
  - Risk (generally): Used LIFO inventory (vs. increment)
  - Risk: In-transit inventory omitted
• **Simplified service cost method** (mixed service costs)
  - Risk: SSCM ratio applied to *less than total* department costs

• **Tax adjustments omitted** (IRS exam position)
  - Risk (if tax > book expense): Depreciation, compensation (bonus, vacation), occupancy (rent, property taxes, insurance)

Ellen McElroy, Pepper Hamilton

IMPACT OF RECENT AND FORTHCOMING GUIDANCE
Expected Guidance Under Sect. 263A

- Treatment of sales-based royalties
- Engineering costs
- Negative additional Sect. 263A costs
- Guidance for auto dealerships
Royalties: General rules

• Royalties are payments made for the use of property covered by a patent, copyright or trademark.

• The specific terms for royalties may vary depending on the deal struck between the parties, and royalty payments can be made on a continuum triggered by production or sales.
Robinson Knife Decision And Anticipated Guidance (Cont.)

- **Sales-based royalties**
  - Due on the sale of the subject items
  - For pure sales-based royalties, royalty costs arise only after sales are made, and no royalty is due if no sales occur.

- **Production-based royalties**
  - Due for the right to produce the subject items
  - Generally, liability for these royalties exists at production (or before).
  - Eventual sales of the items, whether or not they occur, have no bearing on pure-production based royalties.

- **Royalty terms** control whether the costs are attributable to production (capitalized under Sect. 263A) or attributable to sales (deducted), regardless of when the payment is actually made.
Facts:

- Robinson Knife entered into licensing agreements to sell its products under Pyrex, Oneida and other brand names.
- The company agreed to pay sales-based royalties to the trademark holders.
  - The royalty was a percentage of the net wholesale billing price of the products sold.
  - No minimum or lump-sum royalty payment was required; no royalties were accrued prior to sale of the products.

Issue: Were the royalty payments deductible as ordinary and necessary business expenses under Sect. 162, or were the payments a cost of production required to be capitalized to inventory under Sect. 263A?
Robinson Knife: TP And IRS Arguments

- Robinson Knife argued that the royalties were deductible.
  - Several arguments were made, but chiefly that the royalties were independent of any production activities, based solely on sales, and not “properly allocable to the property produced” under Treas. Reg. § 1.263A-1(e)(3)(i).
  - Company did not challenge the validity of the Sect. 263A regulations; rather, Robinson Knife only challenged the interpretation and application.

- The IRS argued that the royalties should be capitalized as indirect costs allocable to production under Treas. Reg. § 1.263A-1(e)(3)(i).
  - Agency argued the royalties directly benefited production activities and were incurred by reason of those activities.
Robinson Knife: Analysis And Holding

• Second Circuit found that royalty payments:
  (i) Calculated as a percentage of sales revenue from certain inventory and
  (ii) Incurred only upon the sale of such inventory are not required to be capitalized under Sect. 263A.

• While the license agreements addressed production activities, Robinson Knife’s royalty costs were not “properly allocable to property produced” under Treas. Reg. § 1.263A-1(e)(3)(i) “[I]t is the costs, and not the contracts pursuant to which those costs are paid, that must be a but-for cause of the taxpayer’s production activities in order for the costs to be properly allocable to those activities and subject to the capitalization requirement.”
Robinson Knife Decision And Anticipated Guidance

• Treasury and IRS are close to completing Sect. 263A guidance addressing sales-based royalties.

• Decision caused the government to re-think guidance regarding royalty costs.
  - Government had indicated that there is a broad spectrum of arrangements between pure sales-based royalties and pure production-based royalties.
  - An analysis of royalty payments must consider factual differences in various arrangements.
  - It must consider whether royalty is being paid for use of know-how, formula, special recipe or other insights regarding production, as these factors could suggest that the royalties benefit production.

• Guidance is expected within the next several months.
• Under Sect. 263A, indirect costs include engineering and design costs that are not research and experimental expenditures under Sect. 174 and its regulations. See Treas. Reg. § 1.263A-1(e)(3)(ii)(P).

• Sect. 174(a) provides that a taxpayer may deduct research or experimental expenditures incurred in connection with its trade or business.
Cost classification

- Treas. Reg. § 1.263A-1(e)(4)(ii)(A): Service costs that directly benefit production or are incurred in production or resale activities are capitalizable.

- Treas. Reg. § 1.263A-1(e)(4)(ii)(B): Service costs that do not directly benefit production or are not incurred in production or resale activities are not required to be capitalized.

- Treas. Reg. § 1.263A-1(e)(4)(ii)(C): Mixed service costs are costs partially allocable to production activities (capitalizable) and partially allocable to non-production activities (deductible).

The classification of mixed service costs plays a role in the simplified service cost method under Treas. Reg. § 1.263A-1(h), which looks to the aggregate portion of mixed service costs that are properly allocable to production or resale activities.
Facts

• Taxpayer, a utility, had an engineering department that incurred costs attributable to production activities as well as costs attributable to certain other research and experimental activities.

• Taxpayer analyzed its departments and treated the engineering department as a mixed service department, incurring both capitalized costs and deductible Sect. 174 costs.

**Issue:** Whether the engineering department’s Sect. 174 costs were attributable to non-production activities, giving rise to mixed services costs and a mixed service department.
Taxpayer
– The taxpayer claimed that its engineering department incurred Sect. 174 costs, and thus, the department had mixed service costs.

IRS director
– The IRS director argued that, despite incurring Sect. 174 costs, these costs were still allocable to production activity.

– Certain indirect costs are not required to be capitalized, including selling and distribution costs, research and experimental expenditures, Sect. 179 costs (for certain depreciable assets), Sect. 165 losses, and deductible service costs. Treas. Reg. § 1.263A-1(e)(3)(iii).

• Argued that even if these costs were exempt from capitalization under Sect. 263A, it does not mean that the costs are not attributable to production activities. If all costs are allocable to production, then the costs cannot qualify as mixed service costs.
Analysis and holding

- Even though certain indirect costs are not required to be capitalized, Sect. 179 costs (for certain depreciable assets) or Sect. 165 losses (abandonment losses) do not involve engaging in any separate activity.
  - These Sect. 179 costs and Sect. 165 losses incurred by a department would not give rise to mixed service costs under Treas. Reg. § 1.263A-1(e)(4)(ii)(C).

- However, costs qualifying as research and experimental expenditures under Sect. 174 arise from and are allocable to activity that is separate non-production and non-resale activity under Treas. Reg. § 1.263A-1(e)(4)(ii)(C).
  - The costs incurred by the engineering department, therefore, were mixed service costs, and the engineering department was a mixed service department.
Negative additional Sect. 263A costs – Background

• Sect. 471 and its regulations provide general rules for inventories and valuation.

• Sect. 263A and its regulations provides rules for the capitalization of certain direct and indirect costs for property produced or held for resale.
  • These regulations provide several detailed or specific cost allocation methods, or taxpayers may use the simplified methods.
    – The simplified production method under Treas. Reg. § 1.263A-2(b), or
    – The simplified resale method under Treas. Reg. § 1.263A-3(d)
Negative additional Sect. 263A costs – Background (Cont.)

The simplified methods determine the aggregate amounts of additional Sect. 263A costs allocable to ending inventory.

• Additional Sect. 263A costs generally are the costs that were not capitalized under the taxpayer’s method of accounting used immediately prior to Sect. 263A’s effective date.

• Additional Sect. 263A costs allocable to ending inventory are determined by multiplying Sect. 471 costs remaining on hand at year end by an absorption ratio, consisting of additional Sect. 263A costs incurred during the taxable year over Sect. 471 costs incurred during the taxable year.
Negative additional Sect. 263A costs – Background (Cont.)

Negative amounts may occur if a taxpayer includes book costs greater than those required for tax purposes in the Sect. 471 cost of inventory.

- For example, if book depreciation is greater than tax depreciation, the taxpayer may have capitalized too much depreciation for purposes of Sect. 263A and must reduce total Sect. 263A costs by the excess.

- Some taxpayers do not adjust their Sect. 471 costs to remove the excess amounts, and make a negative additional Sect. 263A cost adjustment instead.

This notice invited public comments on changes to the simplified production method and simplified resale method under Treas. Reg. §§ 1.263A-2(b) and -3(d), respectively, as they relate to negative additional Sect. 263A costs.

The IRS and Treasury are concerned that including negative amounts in additional Sect. 263A costs may cause distortions.

- They are considering amending the regulations to prohibit the use of some or all negative amounts for the simplified methods.

- Also, they are considering providing a new method (i) to allow negative amounts for additional Sect. 263A costs, (ii) to avoid requiring changes to existing systems for determining Sect. 471 costs, and (iii) to reduce distortions.
Interim guidance

• Notice 2007-29 provides that the IRS will not challenge the inclusion of negative amounts and will not raise the issue in any taxable year ending on or before the publication of guidance. If the issue had already raised in examination, the IRS generally chose not to pursue it further.

• The IRS also stated it would not deny consent for changes in methods of accounting solely based on negative amounts in computing additional Sect. 263A costs.
Two auto dealership directives

The first directive was issued Sept. 15, 2009.

• References Technical Advice Memorandum 200736026 as providing instructive legal reasoning for auto dealership examinations.
  – Auto dealerships were defined as businesses that sell and service new and/or used passenger vehicles, light trucks, and medium and heavy duty trucks.

• To allow taxpayers an opportunity to comply with the rules and change methods of accounting, the IRS suspended examinations of auto dealerships from Sept. 15, 2009 to Dec. 31, 2010.
Two auto dealership directives (Cont.)

The second directive was issued Aug. 9, 2010.

- This directive provides that the IRS is considering additional published guidance on auto dealership Sect. 263A issues and issues raised in Technical Advice Memorandum 200736026.

- In anticipation of this guidance, the IRS extended the audit suspension period until the date the pending guidance is published.
Technical Advice Memorandum 200736026 (Sept. 7, 2007)

Discusses a variety of auto dealership issues and their treatment under current law. The issues discussed include:

- Treatment of installation and repair activities on customer-owned vehicles and new and used vehicles owned by the auto dealership
- Treatment of certain sales as “on-site sales to retail consumers”
- Mixed service cost issues.

Forthcoming guidance

- Timing expectations
- Content expectations