

## Part I

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

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

Rev. Rul. 2005-53

#### BACKGROUND

In Notice 2003-36, 2003-1 C.B. 992, modified by Notice 2003-59, 2003-2 C.B. 429, the Treasury Department and the Internal Revenue Service indicate that they are aware that uncertainty exists as to what types of property constitute “eligible property” under §§ 1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D) of the Income Tax Regulations for which qualifying taxpayers may use the simplified service cost and simplified production methods. In particular, there is uncertainty about the proper interpretation and application of the term “routine and repetitive.” The notice indicates that the Treasury Department and the Service plan to publish guidance that will clarify the types of property that qualify as eligible property under those sections and address the interpretation and application of the term “routine and repetitive.” This revenue ruling

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

## ISSUE

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

## FACTS

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

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

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

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

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

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

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

## LAW AND ANALYSIS

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

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

Service costs include capitalizable service costs, deductible service costs, and mixed

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

#### HOLDING

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

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

#### DRAFTING INFORMATION

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