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subject: Allocation of Capitalizable Mixed Service Costs to Ineligible Property

This memorandum responds to your request for guidance on an issue affecting multiple taxpayers in the utility industry. Specifically, this memorandum provides generic legal advice regarding allocations of capitalizable mixed service costs to ineligible property under the simplified service cost method. The same analysis applies to allocations of additional § 263A costs under the parallel provisions of the simplified production method.

This memorandum may not be used or cited as precedent. It is intended only for use by the office that requested it.

ISSUE

Is a utility company that elects to use the simplified service cost method to determine capitalizable mixed service costs with respect to eligible property required to allocate mixed service costs to property that is not eligible for the simplified service cost method using the methods provided in § 1.263A-1(g)(4) of the Income Tax Regulations?

CONCLUSION

A utility company that elects to use the simplified service cost method to determine capitalizable mixed service costs with respect to eligible property is required to allocate mixed service costs to property that is not eligible for the simplified service cost method using the methods provided in § 1.263A-1(g)(4).

FACTS

The allocation of mixed service costs is increasingly an issue in the utility industry.¹ The majority of the taxpayers in this industry are fully-integrated public utilities engaged in the generation, transmission and distribution of electricity. Other utilities engage in little or no generating activity. These utilities purchase electricity from other utilities and engage only in the transmission and distribution of electricity. Both types of utilities produce self-constructed assets (including, as applicable, generation, transmission and distribution assets that constitute non-inventory property) for use in their trade or business. The costs of producing these self-constructed assets must be capitalized under § 263A of the Internal Revenue Code. Utilities account for these assets as fixed assets and recover the costs to produce them over the recovery periods provided in § 167 and § 168 and the regulations thereunder. Applicable recovery periods for these assets generally range from 15 to 30 years.

The issue under consideration in this memorandum arises when a utility uses the simplified service cost method to determine capitalizable mixed service costs incurred during the year with respect to production of electricity (as applicable), purchased assets, and self-constructed assets. In applying the simplified service cost method, some utilities use the production cost allocation ratio and allocate all of their capitalizable service costs to eligible property – most of which is electricity inventory that does not remain on hand at year end – and treat none of their service costs as allocated to ineligible property.

LAW AND ANALYSIS

Under § 263A(a) and (b), 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(a)(3)(ii) restates the foregoing rule by providing that taxpayers that produce real property and tangible personal property must capitalize all the direct costs of producing the property and the property's allocable share of indirect costs.

Indirect costs include service costs, which include capitalizable service costs, deductible service costs, and mixed service costs. § 1.263A-1(e)(3)(i), (ii)(W) and (4)(ii)(A), (B) and (C). Mixed service costs are service costs that are partially allocable

¹ Whether any particular taxpayer's facts differ materially from the facts described in this memorandum must be determined by the Director.

to production or resale activities and partially allocable to non-production or non-resale activities. § 1.263A-1(e)(4)(ii)(C).

Section 1.263A-1(g)(4) provides that, using reasonable factors or relationships, a taxpayer generally must allocate mixed service costs to property produced using a direct reallocation method, a step-allocation method, or any other reasonable method (as defined in § 1.263A-1(f)(4)).

However, § 1.263A-1(h) permits taxpayers to elect 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.” For purposes of the simplified service cost method, eligible property is limited to property that is subject to § 263A and that falls within the following categories: (1) inventory; (2) non-inventory property held for sale; (3) self-constructed assets that are 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 that is held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business; and (4) 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-1(h)(2)(i) and § 1.263A-1T(h)(2)(i)(D).

Rev. Rul. 2005-53, 2005-35 I.R.B. 425, holds that for purposes of §§ 1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D), in effect for taxable years ending prior to August 2, 2005, 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.

For taxable years ending on or after August 2, 2005, § 1.263A-1T(h)(2)(i)(D) and § 1.263A-2T(b)(2)(i)(D) provide that self-constructed tangible personal property is produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer’s trade or business when units of tangible personal property (as defined in § 1.263A-10(c)) are mass-produced, i.e., numerous substantially identical assets are manufactured within a taxable year using standardized designs and assembly line techniques, and the applicable recovery period of the property determined under § 168(c) is not longer than three years.

Generally, if a taxpayer elects to use the simplified service cost method, it must use the method for all production and resale activities of the trade or business associated with eligible property. See § 1.263A-1(h)(2). However, at its election, a taxpayer may exclude self-constructed assets from application of the simplified service cost method and only apply the method to inventory property and non-inventory property held for sale. See § 1.263A-1(h)(2)(ii). A taxpayer that makes such election must nonetheless allocate service costs to self-constructed assets in accordance with the general allocation rules provided for such costs in § 1.263A-1(g)(4). See Id.

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. § 1.263A-1(h)(3). The allocation ratio can be either labor-based or production-based. See §§ 1.263A-1(h)(4) and (5). The production-based ratio is the ratio of the taxpayer's § 263A production costs to its total costs. See § 1.263A-1(h)(5)(i). For this purpose, § 263A production costs are defined as the total costs (excluding mixed service costs and interest) allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities) under § 263A that are incurred in the taxpayer's trade or business during the taxable year. Total costs include all direct and indirect costs allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities) as well as all other costs of the taxpayer's trade or business. Such costs do not include taxes assessed on the basis of income, as defined in § 1.263A-1(e)(3)(iii)(F). See § 1.263A-1(h)(5)(ii). Total mixed service costs are defined as the total costs incurred during the taxable year in all departments or functions of the taxpayer's trade or business that perform mixed service activities. See § 1.263A-1(h)(6).

Some utilities assert that the simplified service cost method exempts self-constructed assets that are not eligible property from the statutory requirement to capitalize mixed service costs. Accordingly, these utilities reason that it would be improper to apply the simplified service cost method by excluding (a) production costs of general and intangible assets from the production cost allocation ratio and (b) service costs associated with these assets from total mixed service costs. They reason further that the mixed service costs that they allocate using the simplified service cost method must be allocated solely to inventory and eligible self-constructed assets, and not to ineligible property. In other words, they argue that, under the simplified service cost method, all capitalizable service costs must be allocated to eligible property – most of which is electricity inventory that does not remain on hand at year end – and none may be allocated to ineligible property.

This argument is premised on (a) the definitions of § 263A production costs and total mixed service costs contained in § 1.263A-1(h)(5) and § 1.263A-1(h)(6), (b) the simplified service cost allocation formula, and (c) the lack of an express rule in the simplified service cost method regulations stating that ineligible property attracts capitalizable mixed service costs. The general allocation formula under the simplified service cost method is the allocation ratio multiplied by total mixed service costs. The issue under consideration arises when a utility uses the production cost allocation ratio. The numerator of the production cost allocation ratio is “§ 263A production costs,” which is defined under § 1.263A-1(h)(5)(ii) as the total costs (excluding mixed service costs and interest) allocable to property produced under § 263A that are incurred in a taxpayer's trade or business during the taxable year. The utilities argue that the numerator of the production cost allocation ratio should include production costs associated with all of its assets (including those that are eligible property and those that are not eligible property, such as general plant and intangible assets and self-

constructed assets that are not produced on a routine and repetitive basis under Rev. Rul. 2005-53, 2005-35 I.R.B. 425, or § 1.263A-1T(h)(2)(i)(D)) and total mixed service costs should include all mixed service costs, regardless of whether such costs are associated with property that is not eligible for the simplified service cost method.

In support of this position, the utilities reason that the drafters of the simplified service cost method regulations understood that most of a taxpayer's self-constructed assets would qualify as eligible property and that mixed service costs are more or less fixed costs of the business that do not increase as a result of the rare or occasional production of ineligible property. Thus, according to these taxpayers, the Internal Revenue Service (the Service) and Department of the Treasury (Treasury) concluded that mixed service costs need not be allocated to ineligible property under the simplified service cost method.

We disagree with the argument that capitalizable mixed service costs are not allocable to ineligible property if the taxpayer uses the simplified service cost method. Their proposed application of the simplified service cost method – allocation of capitalizable service costs exclusively to eligible property – is inherently unreasonable and ignores the basic requirement of § 263A(a), i.e., that producers of real or tangible personal property must capitalize the direct costs and a proper share of the indirect costs of producing such property. See also § 1.263A-1(a)(3)(ii). For this purpose, indirect costs include capitalizable service costs, deductible service costs, and mixed service costs. See § 1.263A-1(e)(4).

The utilities' argument is also inconsistent with the text of § 1.263A-1(h). Section 1.263A-1(h) provides a method for determining mixed service costs incurred "with respect to eligible property." By its terms, the simplified service cost method only applies to eligible property. See § 1.263A-1(h)(1). Section 1.263A-1(h) does not purport to determine the amount of mixed service costs incurred with respect to other property. Further, § 1.263A-1(h) does not indicate that the general allocation rule provided by § 1.263A-1(g)(4) does not continue to apply in the case of property that is not eligible for the simplified service cost method.

Moreover, like the simplified service cost method, the simplified production method, provided in § 1.263A-2(b), applies only to "eligible property." Eligible property is defined in the same manner for both the simplified service cost method and the simplified production method. See §§ 1.263A-1(h)(2)(i) and 1.263A-2(b)(2)(i). More specifically, §§ 1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D) (by cross-reference to §§ 1.263A-1T(h)(2)(i)(D) and 1.263A-2T(b)(2)(i)(D), respectively), both provide that self-constructed assets produced on a routine and repetitive basis in the ordinary course of a taxpayer's business are eligible property for purposes of the simplified service cost method and the simplified production method, respectively.

Thus, the utilities' argument regarding the simplified service cost method also would apply to additional § 263A costs where the taxpayer elected to use the simplified

production method. In other words, under this argument it would follow that if a utility elected to use the simplified production method, it would not be required to capitalize additional § 263A costs to ineligible property. The similarities between the simplified service cost method and the simplified production method indicate that the subject utilities' speculation about the Service's and Treasury's intent to exempt ineligible property from the requirement to capitalize service costs is incorrect. Even if they were correct that service costs do not increase incrementally as a result of producing ineligible property, there is no basis to conclude that would be true of other additional § 263A costs, e.g., indirect materials and labor, insurance, utilities, etc., required to be capitalized.

The essence of the subject utilities' argument is that the Service and Treasury exempted certain assets from a statutory requirement to capitalize service costs and other indirect costs. There is nothing in § 263A, § 1.263A-1(h), § 1.263A-2(b), the preamble to the final regulations, T.D. 8482, 1993-2 C.B. 77, or Notice 88-86, 1988-2 C.B. 401, to support this position.

The subject utilities cite § 1.263A-1(h)(2)(ii) as evidence that the Service and Treasury know how to write a rule that requires capitalization of service costs to property for which the simplified service cost method is not applied and chose not to draft such a rule for ineligible property. Section 1.263A-1(h)(2)(ii) permits a taxpayer to exclude certain self-constructed assets that are eligible property (i.e., 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 that is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, and self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business) from the application of the simplified service cost method. Section 1.263A-1(h)(2)(ii) expressly provides, however, that if a taxpayer makes this election it is still required to allocate service costs to such excluded self-constructed assets in accordance with the general rules provided by § 1.263A-1(g)(4).

We disagree with the conclusions that these utilities draw from the existence of § 1.263A-1(h)(2)(ii). The provision in § 1.263A-1(h)(2)(ii) requiring allocation of service costs to self-constructed assets excluded from the election is consistent with the statutory requirement to allocate indirect costs, including service costs, to all property subject to § 263A. The provision is not an arbitrary "rule"; it is simply a reminder that service costs must be allocated to property subject to § 263A notwithstanding the fact that the simplified service cost method will be applied only to some of the eligible property. A similar provision for ineligible property is not expressed in § 1.263A-1(h) because that paragraph only applies to eligible property. The provision in § 1.263A-1(h)(2)(ii) is pertinent to the election to exclude eligible self-constructed assets from the application of the simplified service cost method because the assets excluded from the election are in fact eligible property.

Finally, the subject utilities argue that § 1.263A-1(h) determines the total amount of capitalizable mixed service costs incurred by the taxpayer and allocates the total to eligible property. To the contrary, the simplified service cost method does not purport to determine the total amount of capitalizable mixed service costs incurred by the taxpayer; § 1.263A-1(h)(1) expressly states that the simplified service cost method determines the amount of capitalizable mixed service costs incurred with respect to eligible property. In addition, § 1.263A-1(h)(2)(ii) clearly indicates that a taxpayer that elects to exclude self-constructed assets from its application of the simplified service cost method must nonetheless allocate service costs to such property in accordance with the general rules provided by § 1.263A-1(g)(4). Section 1.263A-1(h)(7) also makes clear that a taxpayer that uses the simplified service cost method for one trade or business and not another must allocate the costs of any mixed service department that supports both trades or businesses between those trades or businesses consistent with the principles of § 1.263A-1(f)(4). See § 1.263A-1(h)(7). Thus, §§ 1.263A-1(h)(2)(ii) and (h)(7) clearly recognize that a taxpayer may incur capitalizable mixed service costs that must be allocated to property that is not accounted for using the simplified service cost method.

In summary, the arguments concerning the requirement to allocate capitalizable mixed service costs to ineligible property are inconsistent with the statutory language of § 263A, the intent of the § 263A regulations, and the text of § 1.263A-1(h)(2)(ii) and (h)(7). Moreover, such arguments are not supported by the history and evolution of the simplified service cost method regulations.

Please call Steve Gee at (202) 622-4970 if you have any further questions.