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Memorandum

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to: Area Counsel (Heavy Manufacturing & Transportation)
(Large & Mid-Size Business)

from: Associate Chief Counsel
(Income Tax & Accounting)

subject: Request for Taxpayer-Specific CCA

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

a =

b =

c =

d =

e =

f =

g =

h =

ISSUE

Whether the following indirect costs are properly allocable to property produced as a result of Taxpayer's construction and remodeling activities: salaries, pensions and other related costs, and employee benefit expenses of h employees.

CONCLUSION

Yes. The indirect costs at issue directly benefit or are incurred by reason of Taxpayer's performance of production activities. See § 1.263A-1(e)(3)(i) of the Income Tax Regulations. Accordingly, these indirect costs are properly allocable to property produced. Moreover, the indirect costs previously described are specifically identified in § 1.263A-1(e)(3)(ii) as examples of indirect costs that must be capitalized under § 263A of the Internal Revenue Code to the extent they are properly allocable to property produced.

FACTS

Taxpayer is a diversified financial services company. In 2005, Taxpayer opened a banking stores, b regional commercial banking offices, and remodeled c banking stores. In 2006, Taxpayer opened d banking stores and remodeled e banking stores.

Taxpayer employs a group of employees in a unit known as the h. The primary function of the h is to manage the space needs of the bank. For the years 2005 and 2006, the h employed approximately f full-time equivalent employees. Their responsibilities include overseeing leasing, maintenance and repairs, space configuration, remodeling, and construction activities. Of the full-time equivalent employees, approximately g were involved to some degree in construction activities.

Taxpayer capitalized the direct costs of property produced as a result of h's construction and remodeling activities but did not capitalize certain indirect costs. These indirect costs include internal salaries, pensions and other related costs, and employee benefit expenses of the h employees.

LAW AND ANALYSIS

Sections 263A(a) and (b) provide that allocable costs of real or tangible personal property produced by the taxpayer must be capitalized.

Section 263A(a)(2) provides that the term "allocable costs" of real or tangible property produced by the taxpayer are the direct costs of this property and the property's proper share of those indirect costs (including taxes) part or all of which are allocable to the property.

Section 1.263A-1(a)(3)(i)(A) provides taxpayers must capitalize all direct costs and certain indirect costs properly allocable to real property and tangible personal property produced by the taxpayer.

Section 1.263A-1(a)(3)(ii) provides that taxpayers that produce real property and tangible personal property (producers) must capitalize all the direct costs of producing the property (described in § 1.263A-1(e)(2)(i)) and the property's properly allocable

share of indirect costs (described in § 1.263A-1(e)(3)), regardless of whether the property is sold or is used in the taxpayer's trade or business.

Section 1.263A-1(c)(1) provides that taxpayers must capitalize their direct costs and a properly allocable share of their indirect costs to property produced.

Section 1.263A-1(c)(3) provides that capitalize means, in the case of property that is produced by the taxpayer, to charge to a capital account or basis.

Section 1.263A-1(d)(1) provides that self-constructed assets are assets produced by a taxpayer for use by the taxpayer in its trade or business. Self-constructed assets are subject to § 263A.

Section 1.263A-1(e)(1) provides that, in general, taxpayers subject to § 263A must capitalize all direct costs and certain indirect costs properly allocable to property produced.

Section 1.263A-1(e)(3)(i) provides that indirect costs are defined as all costs other than direct material costs and direct labor costs in the case of property produced. Taxpayers subject to § 263A must capitalize all indirect costs properly allocable to property produced. Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities.

Section 1.263A-1(e)(3)(ii) provides examples of indirect costs required to be capitalized to property produced. These examples include, but are not limited to, indirect labor costs, officers' compensation, pension and other related costs, and employee benefit expenses.

Section 1.263A-1(e)(3)(ii)(A) provides that indirect labor costs include all labor costs (including the elements of labor costs set forth in § 1.263A-1(e)(2)(i)) that cannot be directly identified or associated with particular units or groups of units of specific property produced (e.g., factory labor that is not direct labor). As in the case of direct labor, indirect labor encompasses full-time and part-time employees, as well as contract employees and independent contractors.

Section 1.263A-1(e)(3)(ii)(B) provides that officers' compensation includes compensation paid to officers of the taxpayer.

Section 1.263A-1(e)(3)(ii)(C) provides that pension and other related costs include contributions paid to or made under any stock bonus, pension, profit sharing or annuity plan, or other plan deferring the receipt of compensation, whether or not the plan qualifies under § 401(a). Contributions to employee plans representing past services must be capitalized in the same manner (and in the same proportion to property currently being acquired or produced) as amounts contributed for current service.

Section 1.263A-1(e)(3)(ii)(D) provides that employee benefit expenses include all other employee benefit expenses (not described in § 1.263A-1(e)(3)(ii)(C)) to the extent such expenses are otherwise allowable as deductions.

Section 1.263A-2(a) provides, in general, that § 263A applies to real property and tangible personal property produced by a taxpayer for use in its trade or business. In addition, § 263A applies to property produced for a taxpayer under contract with another party.

Section 263A(g)(1) and § 1.263A-2(a)(1)(i) provide, for purposes of § 263A, that the term “produce” includes the following: construct, build, install, manufacture, develop, improve, create, raise, or grow.

Section 1.263A-2(a)(3)(i) provides that, except as specifically provided in § 263A(f) with respect to interest costs, producers must capitalize direct and indirect costs properly allocable to property produced under § 263A, without regard to whether those costs are incurred before, during, or after the production period (as defined in § 263A(f)(4)(B)).

The issue is whether certain indirect costs incurred by Taxpayer, which consist of salaries, pensions and other related costs, and employee benefit expenses of the h employees, are properly allocable to property produced by Taxpayer and, accordingly, must be capitalized under § 263A.

The specific issue raised by the examining agent is whether Taxpayer is required to capitalize indirect costs related to self-constructed assets and improvements to self-constructed assets under § 263A. The fact that Taxpayer self constructs assets is indisputable. A substantial portion of the work of the h involves overseeing the construction of and contracting for the construction of self-constructed assets. Thus, a portion of the salaries, pensions and other related costs, and employee benefit expenses identified by the examining agent are incurred by reason of activities of the h employees that result in the production of property under § 263A. Like the transportation property in Commissioner v. Idaho Power Co., 418 U.S. 1, 94 S. Ct. 2757, 41 L. Ed. 2d 535 (1974) (discussed below), the indirect costs at issue -- salaries, pensions and other related costs, and employee benefit expenses -- are costs that directly benefit or are incurred by reason the construction of self-constructed assets. Moreover, these indirect costs are explicitly identified by the regulations as categories of indirect costs that are required to be capitalized under § 263A. See § 1.263A-1(e)(3)(ii). Accordingly, Taxpayer must capitalize these indirect costs to the property produced as a result of h's construction and remodeling activities.

For its part, Taxpayer believes that the indirect costs at issue should be analyzed under Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000). As explained below, Wells Fargo is irrelevant to the issue of whether these costs must be capitalized to real and tangible personal property under § 263A.

In Wells Fargo, corporate officers of a subsidiary spent part of their time negotiating a merger transaction with the taxpayer. The subsidiary paid the officers the same compensation that it was paying them to perform their day-to-day operational duties. After completion of the merger, the taxpayer, which became the 100 percent owner of the subsidiary, deducted the portion of the salaries paid to these corporate officers that was attributable to services performed in merging the companies.

The Wells Fargo Court analyzed whether the indirect costs at issue (salaries paid to corporate officers) were “ordinary” under § 162(a) and thus fully deductible in the taxable year, or whether these costs were capital expenditures under § 263(a).¹ In applying the origin of the claim doctrine, the Wells Fargo Court concluded “that if an expense is *directly* related to the capital transaction (and therefore, the long term benefit), then it should be capitalized.”² In reversing the Tax Court, the Wells Fargo Court held that the salaries at issue were currently deductible because “there is only an *indirect* relationship between the salaries (which originate from the employment relationship) and the acquisition (which provides the long term benefit []).”³

Wells Fargo simply does not apply here. The Wells Fargo Court addressed whether the costs to create an *intangible asset* must be capitalized under § 263(a). Accordingly, we disagree with Taxpayer’s argument that the “direct relationship” test in Wells Fargo should be used in determining whether the costs at issue constitute indirect costs under § 1.263A-1(e)(3)(i) because, in Taxpayer’s case, the examining agent is arguing that the indirect costs at issue must be capitalized to *real property and tangible personal property* produced as a result of the h’s construction and remodeling activities.

A brief history of § 263A may be helpful at this point. Prior to enactment of § 263A, the issue of whether a taxpayer must capitalize the cost of constructing real property and tangible personal property was addressed on a case-by-case basis and yielded different results for different industries. In Idaho Power, the Supreme Court held that § 263(a)(1) of the 1954 Code bars depreciation deductions on transportation equipment, including passenger cars, trucks, power-operated equipment, and trailers, that a taxpayer owned and used in the construction of the taxpayer’s capital facilities. The Idaho Power Court reasoned that the depreciation on the transportation equipment is similar to “wages paid in connection with the construction or acquisition of the capital asset,” which “must be

¹ Wells Fargo, 224 F.3d at 880 (citing INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 112 S. Ct. 1039, 117 L. Ed. 2d 226 (1992) (holding that, while “the mere presence of a future benefit may not warrant capitalization, a taxpayer’s realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether” the expense should be deducted or capitalized); Commissioner v. Lincoln Savings and Loan Assoc., 403 U.S. 345, 29 L. Ed. 519, 91 S.Ct. 1893 (1971) (holding that a taxpayer must capitalize an amount paid to create or enhance a separate and distinct asset)).

² Id. at 887 (citing INDOPCO, 503 U.S. 79) (emphasis in original).

³ Id. (emphasis in original).

capitalized and are then entitled to be amortized over the life of the capital asset so acquired.”⁴

In 1986, Congress, unsatisfied with this “case-by-case” approach, effectively codified and extended the Idaho Power result to production activities of all industries by enacting § 263A. See §§ 263A(a)(1)(B), (a)(2), and (b)(1). Section 263A and the regulations thereunder require a taxpayer who produces real property and tangible personal property to capitalize the property’s properly allocable share of indirect costs to the property produced, regardless of whether the property is sold or is used in the taxpayer’s trade or business. See § 263A and § 1.263A-1(a)(3)(ii). These statutory and regulatory rules are intended to provide uniform rules regarding capitalization of direct and indirect costs of producing real property and tangible personal property, regardless of the industry involved or the type of real property and tangible personal property produced.

Accordingly, the issue, properly stated, is whether the h’s costs, consisting of salaries, pensions and other related costs, and employee benefit expenses, are properly allocable to property produced as a result of the h’s construction and remodeling activities. See § 1.263A-1(e)(3)(i). The criteria for analyzing and determining whether those costs are properly allocable under § 263A to the *real property* and *tangible personal property* produced by the taxpayer are found in § 1.263A-1(e)(3). The analysis of the Wells Fargo Court to determine whether costs are allocable or capitalizable to *intangible property* under § 263(a) is simply irrelevant. Moreover, reliance on that judicial analysis of § 263(a) would be a reversion to the state of affairs that Congress sought to remedy by enacting § 263A.

The indirect costs at issue must be capitalized under § 263A because the costs directly benefit and are incurred by reason of h’s performance of production activities. Taxpayer’s reliance on the Wells Fargo decision to argue that these costs are currently deductible is misplaced.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

⁴ Idaho Power Co., 418 U.S. at 13 (citing Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 781 (2nd Cir. 1973); Perlmutter v. Commissioner, 44 T.C. 382, 404 (1965), aff’d, 373 F.2d 45 (10th Cir. 1967); Jaffa v. United States, 198 F.Supp. 234, 236 (ND Ohio 1961); § 1.266-1 (e)).

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