

INTERNAL REVENUE SERVICE  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Number: **201030025**  
Release Date: 7/30/2010

February 18, 2010

Third Party Communication: None  
Date of Communication: Not Applicable

Index (UIL) No.: 263A.01-01  
CASE-MIS No.: TAM-138531-09

Attorney  
CC:LM:RFP:CHI:2M

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification No.  
Year(s) Involved:  
Date of Conference:

LEGEND:

Taxpayer	=	
Date One	=	
Date Two	=	
Date Three	=	
Date Four	=	
<u>A</u>	=	
Date Five	=	
Date Six	=	
Date Seven	=	
Letter Ruling	=	
Date Eight	=	
<u>F</u>	=	

## ISSUES:

(1) Whether Taxpayer's costs attributable to cardboard boxes, dividers, foam packaging, plastic wrapping, heavy plastic bags, and other materials ("packaging material costs") are required to be capitalized as handling costs under § 263A of the Internal Revenue Code because these costs are not costs attributable to pick and pack activities inside a storage or warehousing facility.

(2) Whether Letter Ruling permitted Taxpayer to change its method of accounting for the packaging material costs by reducing the amount of additional section 263A costs contained in the numerator of the simplified production absorption ratio in the amount of the packaging material costs that Taxpayer treated as costs attributable to pick and pack activities that are not required to be capitalized under § 263A.

(3) If we conclude that Taxpayer's packaging material costs are required to be capitalized under § 263A, whether we should apply Ruling (1) prospectively.

## CONCLUSIONS:

(1) The packaging material costs are required to be capitalized as handling costs under § 263A because the packaging material costs are handling costs and these costs are not attributable to pick and pack activities inside a storage or warehousing facility.

(2) Letter Ruling permitted Taxpayer to change its method of accounting for the packaging material costs by reducing the amount of additional section 263A costs contained in the numerator of the simplified production absorption ratio in the amount of the packaging material costs that Taxpayer treated as costs attributable to pick and pack activities that are not required to be capitalized under § 263A.

(3) Taxpayer has satisfied the conditions for § 7805(b) relief, and accordingly, Ruling (1) will be applied prospectively.

## FACTS:

Taxpayer, an S corporation, is engaged in the business of manufacturing, wholesaling, and retailing . Taxpayer's Federal tax returns for the Date One, Date Two, Date Three, and Date Four taxable years are currently under examination. Taxpayer's overall method of accounting is the accrual method.

Taxpayer owns and operates numerous retail stores from which Taxpayer-manufactured is sold. The that Taxpayer produces, whether or not built-to-order, is distributed to unrelated retailers, stores owned by third parties but licensed by Taxpayer, or to stores owned by Taxpayer.

Taxpayer manufactures \_\_\_\_\_ by using an assembly-line process. \_\_\_\_\_ is bagged, placed on a cardboard tray, and heat treated to shrink the bags to better conform to the \_\_\_\_\_. Wooden \_\_\_\_\_ is boxed, which may include placing the \_\_\_\_\_ in Styrofoam® before boxing it. Once packaged, the \_\_\_\_\_ goes into a warehouse, located within the manufacturing facility, for storage. If the \_\_\_\_\_ item is preordered, it is stored in the warehouse until the entire order is completed, at which time the item of inventory is moved to the loading area and placed in a trailer for shipment.

The taxpayer expenses shipping supplies, such as tape, pallets, and cellophane rolls used to hold boxes together during shipment, as these supplies are used.

Approximately A percent of the \_\_\_\_\_ manufactured by Taxpayer is built-to-order; that is, the \_\_\_\_\_ is manufactured after a customer has ordered the specific \_\_\_\_\_. Taxpayer treated only A percent of its packaging material costs as pick and pack costs. After the \_\_\_\_\_ is manufactured, it is packaged using cardboard boxes, dividers, foam packaging, plastic bags and/or other materials as necessary for placement on racking in Taxpayer's warehouses. Generally, Taxpayer's manufacturing facilities and warehouses are single integrated facilities. When ready to be shipped, Taxpayer's built-to-order \_\_\_\_\_ is removed from the racking and loaded onto delivery trucks.

\_\_\_\_\_ that has been ordered by an individual at one of Taxpayer's retail stores is first transported to the retail store. After delivery to the retail store and prior to delivery to the customer who has ordered the \_\_\_\_\_, all packaging materials are removed from the \_\_\_\_\_. The packaging materials are discarded, the \_\_\_\_\_ is loaded onto a delivery truck without the packaging materials, and title to the \_\_\_\_\_ passes to the customer after the \_\_\_\_\_ has been received, inspected, and accepted by the customer at the customer's home.

\_\_\_\_\_ that has been ordered by an unrelated retailer is delivered to the retail store, operated by the unrelated retailer, and is typically shipped with the packaging materials remaining on the \_\_\_\_\_. When \_\_\_\_\_ is shipped to unrelated retail stores or licensed stores, title to the \_\_\_\_\_ does not transfer to Taxpayer's customer (in this case, the unrelated retailer) until the \_\_\_\_\_ has been received, inspected, and accepted by the unrelated retailer.

All \_\_\_\_\_ that is manufactured, whether or not preordered, is packaged with the necessary packaging material. Thus, all \_\_\_\_\_ is packaged in the same identical packaging whether or not built-to-order.

Taxpayer had included the costs that it had capitalized under its standard cost method in Taxpayer's section 471 costs for purposes of the simplified production

method calculation under § 263A prior to changing its method of accounting (discussed below).

During Date Five, Taxpayer filed a Form 3115, Change in Accounting Method, to change its method of accounting for, among other items, certain packaging and repackaging costs, beginning with Taxpayer's 52-53 week taxable year beginning Date Six. Taxpayer requested permission to change its accounting for these packaging costs from capitalizing the costs under § 263A to deducting the costs as costs attributable to pick and pack activities under § 1.263A-3(c)(4)(vi)(C) of the Income Tax Regulations.

On Date Seven, the Service granted Taxpayer's request to change its method of accounting for the items subject to Taxpayer's Form 3115, including the packaging costs Taxpayer sought to deduct as pick and pack costs. On Date Eight, the Service issued Letter Ruling, which superseded the letter ruling issued on Date Seven. Letter Ruling contained the following representation made by Taxpayer: "the pick and pack costs [that Taxpayer seeks to deduct] relate to packaging and repackaging material consisting of heavy plastic bags [that] are designed to protect the goods during the distribution process and that the pick and pack costs also related solely to goods [that] have been ordered at the time production is complete."

Taxpayer has elected to use the simplified production method without the historic absorption ratio for computing the additional section 263A costs allocable to eligible property remaining on hand at the end of the taxable year. As part of Taxpayer's simplified production method without the historic absorption ratio for the Date One taxable year, Taxpayer included packaging material purchases in the amount of \$E in the absorption ratio as a negative additional section 263A cost, resulting in a negative absorption ratio.

#### LAW AND ANALYSIS:

##### Costs attributable to pick and pack activities

Taxpayer concedes that the packaging material costs are handling costs. Taxpayer, however, argues that these costs are deductible as costs attributable to pick and pack activities inside a storage or warehousing facility. Accordingly, we will address whether the packaging material costs constitute costs attributable to pick and pack activities under § 1.263A-3(c)(4)(vi)(C). We express no opinion with respect to whether the packaging material costs are handling costs as defined elsewhere in § 1.263A-3(c)(4).

Section 1.263A-3(c)(4)(vi)(C)(1) provides that, generally, handling costs incurred inside a storage or warehousing facility must be capitalized. However, costs attributable to pick and pack activities inside a storage or warehousing facility are not required to be capitalized. Pick and pack activities are activities undertaken in preparation for imminent

shipment to a particular customer after the customer has ordered the specific goods in question. Examples of pick and pack activities include:

- (i) Moving specific goods from a storage location in preparation for shipment to the customer;
- (ii) Packing or repacking those goods for shipment to the customer; and
- (iii) Staging those goods for shipment to the customer.

Section 1.263A-3(c)(4)(vi)(C)(2) provides that activities that are not pick and pack include:

- (i) Unloading goods that are received for storage;
- (ii) Checking the quantity and quality of goods received;
- (iii) Comparing the quantity of goods received to the amounts ordered and preparing the receiving documents;
- (iv) Moving the goods to their storage location, e.g., bins, racks, containers, etc.; and
- (v) Storing the goods.

Taxpayer's packaging material costs are not costs attributable to pick and pack activities. First, the packaging materials in question are applied to all

produced by Taxpayer. All produced by Taxpayer is packaged in the same identical packaging whether or not built-to-order. Thus, the packaging material costs are not undertaken in response to an order from a particular customer.

This fact argues against Taxpayer's position that the packaging material costs are attributable to pick and pack activities. Taxpayer's packaging activities are not undertaken in preparation for imminent shipment to a particular customer; the same packaging material costs are necessary for produced without a preorder. Packaging that Taxpayer uniformly applies to all of its manufactured does not become a pick and pack activity by reason of a customer order.

The treatment of pick and pack costs as an exception to the general rule in the § 263A regulations that handling costs must be capitalized is based on the determination that such costs are like distribution costs and is illustrated by the following example: A book reseller stores several hundred books, boxed by title, in its warehouse. A particular customer places an order for several different titles. Upon receipt of the

order, an employee of the book reseller retrieves the requested titles from several boxes stored in the warehouse, applies plastic wrap to the books, and places the books in a shipping box. The labor and materials used within the reseller's warehouse upon receipt of the customer order constitute pick and pack activities that are not required to be capitalized under § 263A.

Accordingly, Taxpayer's packaging material costs are required to be capitalized as handling costs under § 263A because: (1) Taxpayer concedes that the packaging material costs are handling costs; and (2) Taxpayer's packaging material costs are not attributable to pick and pack activities inside a storage or warehousing facility.

#### Negative amounts included in additional section 263A costs

The second issue is whether Letter Ruling permitted Taxpayer to change its method of accounting for the packaging material costs by reducing the amount of additional section 263A costs contained in the numerator of the simplified production absorption ratio in the amount of the packaging material costs that Taxpayer treated as costs attributable to pick and pack activities that are not required to be capitalized under § 263A. We find that it did. In light of our conclusion, however, that the packaging material costs are required to be capitalized under § 263A because these costs are not the result of pick and pack activities inside a storage or warehousing facility, Taxpayer must include these amounts in the numerator of the simplified production absorption ratio.

#### Section 7805(b) relief

The third issue is whether Taxpayer should be granted relief under § 7805(b) with regard to the treatment of packaging materials as pick and pack costs rather than as costs that must be capitalized under § 263A.

Section 7805(b)(8) provides that the Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws shall be applied without retroactive effect.

Section 13.02 of Rev. Proc. 2010-2, 2010-1 I.R.B. 90, 106, provides that a technical advice memorandum ("TAM") may be used to seek revocation or modification of a private letter ruling ("PLR"). See section 11.03 of Rev. Proc. 2010-1, 2010-1 I.R.B. 1, 49, with respect to revocation or modification of PLRs. Under section 601.204(c) of the Statement of Procedural Rules, the written permission by the national office to a change in a taxpayer's accounting method is a letter ruling. Generally, a TAM that revokes or modifies a letter ruling will not be applied retroactively if: (1) the applicable law has not changed; (2) the taxpayer directly involved in the letter ruling relied in good faith on it; and (3) revocation or modification would be detrimental to the taxpayer.

However, the TAM will be applied retroactively to the taxpayer whose tax liability was directly involved in the letter ruling if: (1) controlling facts have been misstated or omitted; or (2) the facts at the time of the transaction are materially different from the controlling facts on which the letter ruling was based.

In the instant case, the applicable law has not changed since issuance of Letter Ruling. Moreover, no evidence has been presented to suggest that Taxpayer failed to rely on Letter Ruling in good faith, that Taxpayer misstated or omitted controlling facts, or that the facts at the time of the transaction are materially different from the controlling facts on which Letter Ruling was based. Finally, modification of Letter Ruling would result in increased tax liability for Taxpayer's Date One through Date Four taxable years. Accordingly, Ruling (1) will be applied prospectively. However, the Service may exercise its authority to modify the year of change if Taxpayer does not file a Form 3115 to change its treatment of the packaging materials for the taxable year immediately succeeding the taxable year in which the § 7805(b) relief ends.

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.