

**Internal Revenue Service**

Department of the Treasury  
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Person To Contact: \_\_\_\_\_, ID No.

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LEGEND

Year 2 =  
Year 1 =  
Taxpayer =  
Type =  
Purpose =

Dear \_\_\_\_\_ :

This letter responds to your letter dated March 14, 2018, requesting certain rulings concerning the application of § 263A of the Internal Revenue Code and the Income Tax Regulations for a producer that uses the simplified production method and that has inventory that did not completely turn over during the taxable year. You have requested the following rulings:

1. For its Year 2 taxable year, notwithstanding the fact that a portion of Taxpayer's Year 1 ending inventory remained on hand in its Year 2 ending inventory, Taxpayer, using the first-in, first out (FIFO) method and the simplified production method, properly applies the simplified production method by including (1) only the additional section 263A costs that it incurred during the Year 2 taxable year in the numerator of the absorption ratio of the simplified production method formula, (2) only the section 471 costs that it incurred during the Year 2 taxable year in the denominator of the absorption ratio of the simplified production method formula, and (3) only the section 471 costs that it incurred during the Year 2 taxable year and that remained in its inventory at the end of the Year 2 taxable

year in the section 471 costs on hand at year end (“multiplicand”) for purposes of the simplified production method formula.

2. For its Year 2 taxable year, notwithstanding the fact that a portion of Taxpayer’s Year 1 ending inventory remained on hand in its Year 2 ending inventory, Taxpayer, using the FIFO method and the simplified production method, properly determines the additional section 263A costs capitalized to ending inventory in Year 2 by only using the portion of additional section 263A costs incurred during Year 2 that are allocable to ending inventory in Year 2 under the simplified production method, and Taxpayer properly recovers as cost of goods sold in Year 2 the additional section 263A costs that were allocated to ending inventory in Year 1 using the simplified production method.

## FACTS

Taxpayer develops and commercializes Type products for Purpose. Because of the complexity of Taxpayer’s manufacturing processes, Taxpayer produces its products in large batches, and only a limited number of manufacturing facilities can manufacture Taxpayer’s products. Taxpayer is a calendar-year taxpayer that uses an overall accrual method of accounting.

For its Year 1 taxable year, Taxpayer used the FIFO method to identify inventory and the simplified production method without historic absorption ratio election described in § 1.263A-2(b)(3) to allocate additional section 263A costs to ending inventory. For its Year 2 taxable year, Taxpayer continues to use the first-in, first out (FIFO) method to identify inventory and the simplified production method without historic absorption ratio election described in § 1.263A-2(b)(3) to allocate additional section 263A costs to ending inventory. Taxpayer calculates its absorption ratio of the simplified production method by dividing additional section 263A costs that it incurred during the taxable year by section 471 costs that it incurred during the taxable year. Taxpayer’s multiplicand of its simplified production method formula is the section 471 costs that it incurred during the taxable year and that remained in its inventory at the end of the taxable year. Taxpayer multiplies this multiplicand by its absorption ratio to determine its additional section 263A costs allocated to ending inventory.

Taxpayer did not sell all of its Year 1 ending inventory in its Year 2 taxable year, and a portion of its Year 1 ending inventory remained on hand in its Year 2 ending inventory. In Year 2, Taxpayer recovers as costs of goods sold all of the additional section 263A costs that were allocated to ending inventory in Year 1 by the simplified production method.

REQUESTED RULINGS1. Taxpayer Properly Applies the Simplified Production Method Formula in Year 2

Taxpayer's first requested ruling is that, notwithstanding the fact that a portion of Taxpayer's Year 1 ending inventory remained on hand in its Year 2 ending inventory, Taxpayer, using the FIFO method and the simplified production method, properly applies the simplified production method in Year 2 by including (1) only the additional section 263A costs that it incurred during the Year 2 taxable year in the numerator of the absorption ratio of the simplified production method formula, (2) only the section 471 costs that it incurred during the Year 2 taxable year in the denominator of the absorption ratio of the simplified production method formula, and (3) only the section 471 costs that it incurred during the Year 2 taxable year and that remained in inventory at the end of the Year 2 taxable year in the multiplicand of the simplified production method formula.

Section 1.263A-1(d)(2)(i) provides that section 471 costs are the costs, other than interest, that the taxpayer capitalized under its method of accounting immediately prior to the effective date of § 263A.

Section 1.263A-1(d)(2)(ii) provides that, for taxpayers not in existence prior to the effective date of § 263A, section 471 costs generally are the costs, other than interest, that the taxpayer would have been required to capitalize under its method of accounting had it been in existence immediately prior to the effective date of § 263A.

Section 1.263A-1(d)(3) defines additional section 263A costs as 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. For new taxpayers, additional section 263A costs are defined as the costs, other than interest, that the taxpayer must capitalize under § 263A, but which the taxpayer would not have been required to capitalize if the taxpayer had been in existence prior to the effective date of § 263A.

Section 1.263A-2(b) provides a simplified method (the simplified production method) for determining the additional section 263A costs 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) provides generally that under the simplified production method, additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year equal the absorption ratio multiplied by the section 471 costs remaining on hand at year end.

Section 1.263A-2(b)(3)(ii)(A) provides that under the simplified production method, the absorption ratio is the additional section 263A costs incurred during the taxable year divided by the section 471 costs incurred during the taxable year.

Section 1.263A-2(b)(3)(ii)(A)(1) provides that additional section 263A costs incurred during the taxable year are defined as the additional section 263A costs described in § 1.263A-1(d)(3) that a taxpayer incurs during its current taxable year.

Section 1.263A-2(b)(3)(ii)(A)(2) provides that section 471 costs incurred during the taxable year are defined as the section 471 costs described in § 1.263A-1(d)(2) that a taxpayer incurs during its current taxable year.

Section 1.263A-2(b)(3)(ii)(B) provides that section 471 costs remaining on hand at year end means the section 471 costs, as defined in § 1.263A-1(d)(2), that a taxpayer incurs during its current taxable year which remain in its ending inventory or are otherwise on hand at year end.

As a general matter, the § 263A regulations provide that a taxpayer that uses the simplified production method to allocate additional section 263A costs to ending inventory only includes: additional section 263A costs that it incurs during the current taxable year in the numerator of the absorption ratio of the simplified production method formula; only the section 471 costs that it incurs during the taxable year in the denominator of the absorption ratio of the simplified production method formula; and only the section 471 costs that it incurs during the taxable year and that remain in inventory at the end of the taxable year in the multiplicand of the simplified production method formula. The regulations covering the simplified production method do not provide any special rules for inventory that does not completely turn over in a taxable year.

In this case, some of the items in Taxpayer's Year 1 ending inventory were not sold during Year 2, and therefore Taxpayer has items from Year 1 in its Year 2 ending inventory. Regardless, in Year 2, Taxpayer properly determines the numerator and denominator of its absorption ratio of the simplified production method formula by including only the additional section 263A costs that it incurred during the Year 2 taxable year in the numerator, and only the section 471 costs that it incurred during the Year 2 taxable year in the denominator, pursuant to §§ 1.263A-2(b)(3)(i)(A) and -2(b)(3)(ii)(A). Additionally, Taxpayer properly determines the multiplicand of the simplified production method formula by including only the section 471 costs that it incurred during the Year 2 taxable year and that remain in inventory at the end of the Year 2 taxable year pursuant to §§ 1.263A-2(b)(3)(i)(A) and -2(b)(3)(ii)(B).

## 2. Taxpayer Properly Determines Costs Allocated to Ending Inventory and Properly Recovers Certain Costs as Cost of Goods Sold in Year 2

Taxpayer's second requested ruling is that, notwithstanding the fact that a portion of Taxpayer's Year 1 ending inventory remained on hand in its Year 2 ending inventory, Taxpayer, using the FIFO method and the simplified production method, properly

determines the additional section 263A costs capitalized to ending inventory in Year 2 by only using the portion of additional section 263A costs incurred during Year 2 that are allocable to ending inventory in Year 2 under the simplified production method, and that Taxpayer properly recovers as cost of goods sold in Year 2 the additional section 263A costs that were allocated to ending inventory in Year 1 using the simplified production method.

Section 1.263A-1(c) provides that section 263A costs are generally allocated to the items of property produced or property acquired for resale during the taxable year and capitalized to the items that remain on hand at the end of the taxable year.

Section 1.263A-1(f)(1) allows taxpayers to use the simplified method provided in §§ 1.263A-2(b) (the simplified production method) to allocate additional section 263A costs properly allocable to property produced or acquired for resale to property that is on hand at the end of the taxable year.

Section 1.263A-2(b) provides a simplified method (the simplified production method) for determining the additional section 263A costs 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 under the simplified production method, additional § 263A costs allocable to eligible property remaining on hand at the close of the taxable year equal the absorption ratio multiplied by the section 471 costs remaining on hand at year end.

Section 1.263A-2(b)(3)(i)(B) provides generally that the absorption ratio of the simplified production method is multiplied by the section 471 costs remaining in ending inventory or otherwise on hand at the end of each taxable year in which the simplified production method is applied. The resulting product is the additional section 263A costs that are added to the taxpayer's ending section 471 costs to determine the section 263A costs that are capitalized.

As a general matter, the § 263A regulations provide that the simplified production method only treats the additional section 263A costs incurred during the current taxable year as allocable to ending inventory. As described above, those are the only costs that are properly included in the numerator of the absorption ratio of the simplified production method formula. Additionally, the simplified production method allocates additional section 263A costs as a lump-sum to ending inventory (in lieu of allocating those costs to specific items of property, which is generally otherwise required under the § 263A regulations). The regulations covering the simplified production method do not provide any special rules for inventory that does not completely turn over in a taxable year.

In this case, some of the items in Taxpayer's Year 1 ending inventory were not sold during Year 2, and therefore Taxpayer has items from Year 1 in its Year 2 ending inventory. Regardless, none of the additional section 263A costs allocated to Taxpayer's Year 1 ending inventory by the simplified production method are allocable to Taxpayer's Year 2 ending inventory, and all of the additional section 263A costs allocated to Taxpayer's Year 1 ending inventory are properly recovered as cost of goods sold in Year 2. The simplified production method allocates additional section 263A costs to ending inventory as a lump-sum, and not to specific items in ending inventory, and for purposes of determining the additional section 263A costs allocated to Taxpayer's Year 2 ending inventory, it is irrelevant that some of the items in Taxpayer's Year 1 ending inventory are also in Taxpayer's Year 2 ending inventory.

### RULINGS

1. For its Year 2 taxable year, notwithstanding the fact that a portion of Taxpayer's Year 1 ending inventory remained on hand in its Year 2 ending inventory, Taxpayer, using the FIFO method and the simplified production method, properly applies the simplified production method by including (1) only the additional section 263A costs that it incurred during the Year 2 taxable year in the numerator of the absorption ratio of the simplified production method formula, (2) only the section 471 costs that it incurred during the Year 2 taxable year in the denominator of the absorption ratio of the simplified production method formula, and (3) only the section 471 costs that it incurred during the Year 2 taxable year and that remained in its inventory at the end of the Year 2 taxable year in the section 471 costs on hand at year end ("multiplicand") for purposes of the simplified production method formula.
2. For its Year 2 taxable year, notwithstanding the fact that a portion of Taxpayer's Year 1 ending inventory remained on hand in its Year 2 ending inventory, Taxpayer, using the FIFO method and the simplified production method, properly determines the additional section 263A costs capitalized to ending inventory in Year 2 by only using the portion of additional section 263A costs incurred during Year 2 that are allocable to ending inventory in Year 2 under the simplified production method, and Taxpayer properly recovers as cost of goods sold in Year 2 the additional section 263A costs that were allocated to ending inventory in Year 1 using the simplified production method.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Taxpayer's authorized representatives.

Sincerely,

W. Thomas McElroy Jr.  
Senior Technician Reviewer, Branch 6  
(Income Tax & Accounting)