abiding persons will be granted permission to land at interior airports in the U.S. without first landing at one of the airports designated in § 6.14(g). The SSN will be made available to Customs personnel on a need to know basis. Failure to provide the SSN may result in a delay in processing of the application):

(i) Aircraft U.S. registration number(s) and manufacturer's serial number(s) for all aircraft owned or operated by the applicant that will be utilizing the overflight exemption;

(ii) Identification information for each aircraft including class, manufacturer, type, number, color scheme, and type of engine (e.g., turbojet, turbofan, turboprop, reciprocating, helicopter, etc.);

(iii) A statement that the aircraft is equipped with a functioning mode C (altitude reporting) transponder which will be in use during overflight, that the overflights will be made in accord with instrument flight rules (IFR), and that the overflights will be made at altitudes at or above 12,500 feet mean sea level (unless otherwise instructed by Federal Aviation Administration controllers);

(iv) Name and address of the applicant operating the aircraft (if the applicant is a business entity, the address of the headquarters of the business [include state of incorporation if applicable], and the names, addresses, Social Security numbers, and dates of birth of the officers of the business); name, address, Social Security number, and date of birth of the company officer or individual signing the application. If the aircraft is operated under a lease, the name, address, Social Security number, and date of birth of the owner if an individual, or the address of the headquarters of the business [include state of incorporation if applicable], and the names, addresses, Social Security numbers, and dates of birth of the officers of the business;

(v) Individual, signed applications from each usual or anticipated pilot or crewmember for all aircraft for which an overflight exemption is sought stating name, address, Social Security number, Federal Aviation Administration certificate number, and place and date of birth;

(vi) A statement from the individual signing the application as specified in paragraph (f)(1)(iv) of this section that the pilot(s) and crewmember(s) responding to paragraph (f)(1)(v) of this section are those intended to conduct overflights, and that to the best of the individual's knowledge, the information supplied in response to paragraph (f)(1)(v) of this section is accurate;

(vii) Names, addresses, Social Security numbers, and dates of birth for all usual or anticipated passengers (An approved passenger must be on board to utilize the overflight exemption);

(viii) Description of the usual or anticipated baggage or cargo;

(ix) Description of the applicant's usual business activity;

(x) Name(s) of the airport(s) of intended first landing in the U.S. Actual overflights will only be permitted to specific approved airports. (See paragraph (f)(4)(iv) of this section);

(xi) Foreign place or places from which flight(s) will usually originate; and

(xii) Reasons for request for overflight exemption.

(2) If a private aircraft is granted an exemption from the landing requirement specified in paragraph (d) of this section, the aircraft must furnish notice to Customs in accordance with paragraph (d) of this section at least 60 minutes before:

(i) Crossing into the U.S. over a point on the Pacific Coast north of 33 degrees north latitude; or

(ii) Crossing into the U.S. over a point of the Gulf of Mexico or Atlantic Coasts north of 30 degrees north latitude; or

(iii) Crossing into the U.S. over the Southwestern land border (defined as between Brownsville, Texas, and San Diego, California). Southwestern land border crossings must be made while flying in Federal Aviation Administration published airways.

(iv) The notice shall be given to a designated airport specified in paragraph (g) of this section. The notice may be furnished directly to Customs by telephone, radio, or other means, or may be furnished through the Federal Aviation Administration to Customs. If notice is furnished pursuant to this paragraph, notice pursuant to paragraphs (a) and (b) of this section is unnecessary.

(3) All overflights must be conducted pursuant to an instrument flight plan filed with the Federal Aviation Administration prior to the commencement of the overflight.

(4) The owner or aircraft commander of a private aircraft granted an exemption from the landing requirement must:

(i) Notify Customs of a change of Federal Aviation Administration registration number for the aircraft;

(ii) Notify Customs of the sale, theft, modification, or destruction of the aircraft;

(iii) Notify Customs of changes of usual or anticipated pilots or crewmembers as specified in paragraph (f)(l)(v) of this section. Every pilot and crewmember participating in an overflight must have prior Customs approval either through initial application and approval, or through a supplemental application submitted by the new pilot or crewmember and approved by Customs before commencement of the pilot's or crewmember's first overflight.

(iv) Request permission from Customs to conduct an overflight to an airport not listed in the initial overflight application as specified in paragraph (f)(l)(x) of this section. The request must be directed to the district director who approved the initial request for an overflight exemption.

(v) Retain copies of the initial request for an overflight exemption, all supplemental applications from pilots or crewmembers, and all requests for additional landing privileges, as well as a copy of the letter from Customs of approval for each of these requests. The copies must be carried on board any aircraft during the conduct of an overflight.

(vi) The notifications specified in this paragraph must be given to Customs within 5-working days of the change, sale, theft, modification, or destruction, or before a flight for which there is an exemption, whichever occurs earlier.

(5) Applicants for overflight exemptions must agree to make the subject aircraft available for inspection by Customs to determine if the aircraft is capable of meeting Customs requirements for the proper conduct of overflight. Inspections may be conducted during the review of an initial application or at any time during the term of an overflight exemption.

Drafting Information

The principal author of this document was John E. Doyle, Regulations Control Branch, Office of Regulations and Rulings, U.S. Customs Service. However, personnel from other offices participated in its development.

William von Raab,
Commissioner of Customs.

Approved: March 12, 1987.

Francis A. Keating II,
Assistant Secretary of the Treasury.

[FR Doc. 87-7007 Filed 3-27-87; 8:45 am]

BILLING CODE 4820-02-M

Internal Revenue Service

26 CFR Part 1

[T.D. 8132]

Income Tax; Safe Harbor for Certain Installments of Corporate Estimated Tax Due Before July 1, 1987

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations providing a safe harbor for certain installments of corporate estimated tax due before July 1, 1987. The temporary regulations permit a corporation to compute its installment payment or payments due before that date by reference to its taxable income for the preceding year if a subsequent installment payment brings the corporation's aggregate payments for the year up to a specified minimum amount. The regulations assist corporations in complying with the law despite the uncertainty arising from the recent enactment of the Tax Reform Act of 1986 and the Superfund Amendments and Reauthorization Act of 1986.

EFFECTIVE DATE: March 30, 1987.

FOR FURTHER INFORMATION CONTACT: Cynthia E. Grigsby of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224 (Attention: CC:LR:T) (202-343-0232, not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

The Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2085), enacted October 22, 1986, and the Superfund Amendments and Reauthorization Act of 1986 (Pub. L. 99-499, 100 Stat. 1760), enacted October 17, 1986, made changes to the Internal Revenue Code that substantially affect the determination of corporate tax liability. For example, the Tax Reform Act substantially revised Code Section 55 and added new section 263A, relating to capitalization and inclusion in inventory costs of certain expenses. The Tax Reform Act requires corporations to take the alternative minimum tax under section 55 into account in computing their estimated tax payments. The Superfund Amendments and Reauthorization Act added new Code section 59A, relating to environmental tax. That Act requires corporations to take the tax under section 59A into account in computing their estimated tax payments. Sections 55 and 59A are generally effective for taxable years beginning after December 31, 1986. Section 263A generally applies to costs incurred after December 31, 1986, in taxable years ending after that date, except that, in the case of inventory property, section 263A applies to costs incured in taxable years beginning after December 31, 1986.

Because of the substantial number of changes to the Code, corporations may be uncertain about the proper tax treatment of numerous items that they must take into account in determining their estimated tax liability for estimated tax payments due before July 1, 1987. As a result, many corporations are concerned about possible penalties under section 6655 for failure to make adequate installment payments of estimated tax ("the underpayment penalty"). Although some corporations can avoid underpayment penalties by computing their estimates tax liability on the basis of their tax or their income for the preceding year, these special rules are not available to a "large corporation," that is, a corporation with $1,000,000 or more of taxable income in any of its last three taxable years. For many "large corporations," the only practical method of computing installment payments of estimated tax that precludes an underpayment penalty is the "annualization" method.Under the "annualization" method a corporation projects its taxable income for the entire year on the basis of its taxable income for the annualization period. However, because of the substantial changes to the Code many corporations may find it difficult to compute in a timely manner their taxable income for the annualization periods in the first part of the year.

Because of the circumstances described above, the Commissioner of Internal Revenue has determined that proper administration of the tax law requires that corporations using the annualization exception be provided with a special "safe harbor" for the computation of installment payments of corporate estimated tax due before July 1, 1987.

Explanation of Provisions

The temporary regulations provide a safe harbor for certain installment payments of corporate estimated tax due before July 1, 1987. The safe harbor is computer by reference to the regular tax to which the corporation is subject, but the safe harbor payment is treated as including any alternative minimum tax or environmental tax that the corporation is required to include in its estimated tax payments. The safe harbor is available only with respect to installment payments for taxable years beginning after December 31, 1986.

Under the safe harbor provided in the temporary regulations, a corporation using the "annualization" exception provided in section 6655(d)(3) may compute any installment payment of estimated tax due before July 1, 1987, by assuming that its annualized taxable income for the current year equals or exceeds 120 percent of the taxable income shown on its return for the preceding year (adjusted to eliminate any net operating loss deduction). The foreign tax credit for purposes of computing the amount of the safe harbor installment payment is determined on the basis of the foreign tax credit allowed on the return for the proceding year (adjusted for the reduction in tax rates for taxable years beginning after December 31, 1986, and other changes in the foreign tax credit provisions).

The safe harbor refers to the taxable income shown on the return for the preceding year. A corporation that has obtained an extension of time to file its return for the preceding year may be required to make one or two installment payments of estimate tax for the current year before it files that return. However, a corporation must estimate its taxable income to determine the tentative tax that it must show on Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return. Thus, although the corporation may not yet have filed a return, it will have the information that it needs for purposes of the safe harbor.

A corporation may use the safe harbor only if it makes a timely subsequent installment payment of estimated taxes that, when added to the earlier installment payment or payments, equals or exceeds the lesser of (i) 45 percent of the tax shown on its return for the year (67.5 percent, if the subsequent installment is the third installment payment for the year) or (ii) the amount required to satisfy the annualization exception of section 6655(d)(3) (computed without regard to the safe harbor). For purposes of the temporary regulations, the subsequent installment payment is the first installment payment of estimated tax that is not computed under the safe harbor. For example, if a calendar year corporation uses the safe harbor for the first installment payment due April 15, 1987, and does not use the safe harbor for its second installment payment due June 15, 1987, the corporation's second installment payment is required to equal or exceed:

(i) An amount equal to 45% of the tax shown on its return for the year, or

(ii) An amount sufficient to avoid an underpayment penalty under section 6655(d)(3) (applied without regard to the safe harbor).

If a calendar year corporation uses the safe harbor for both the first and second installment payments, the corporation's third installment payment due September 15, 1987, is required to equal or exceed:

(i) An amount equal to 67.5% of the tax shown on its return for the year, or

(ii) An amount sufficient to avoid an underpayment penalty under section 6655(d)(3) (applied without regard to the safe harbor).

If a corporation fails to make the necessary subsequent installment payment, it may be subject to the underpayment penalty under the usual rules for any earlier installment payment. However, § 1.6655-2T(c)(5) of the temporary regulations includes a limitation on the aggregate amount of penalty that may be assessed on any earlier installment payments. The limitation equals the penalty that would be assessed on the deficiency in the subsequent installment payment if the deficiency were treated as an underpayment of estimated tax.

Nonapplicability of Executive Order 12291

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

Regulatory Flexibility Analysis

A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Drafting Information

The principal author of these temporary regulations is Paul A. Francis, of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, on matters of both substance and style.

List of Subjects in 26 CFR 1.6654-1—1.6696-1

Income taxes, Administration and procedure, Penalties, Additions to tax.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1—[AMENDED]

Paragraph 1. The authority for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805.* * *

Par. 2. New § 1.6655-2T is added immediately after § 1.6655-2 to read as follows:

§ 1.6655-2T Safe harbor for certain installments of tax due before July 1, 1987 (temporary).

(a) *Applicability*—(1) *Safe harbor.* The safe harbor provided by paragraph (b) of this section applies only to installment payments of corporate estimated tax required to be made before July 1, 1987, for taxable years beginning in 1987.

(2) *Subsequent payment.* The requirement that a corporation using the safe harbor provided by this section make a timely subsequent installment payment in accordance with paragraph (c) of this section applies with respect to the corporation's first installment payment ("the subsequent installment payment") of estimated tax required to be made after the last payment computed under the safe harbor rule.

(3) *Section inapplicable to new corporation.* This section shall not apply in the case of any corporation whose first taxable year began after December 31, 1986.

(b) *Safe harbor for use of annualization exception*—(1) *In general.* A corporation computing an installment payment of estimated tax using the annualization exception provided in section 6655(d)(3) will not be subject to an addition to tax under section 6655 with respect to an installment payment of estimated tax that satisfies the requirements of this paragraph (b), except as provided in paragraph (c) of this section. For purposes of this paragraph (b)—

(i) A corporation shall assume that its annualized taxable income for the current year equals or exceeds 120 percent of the taxable income shown on its return for the preceding taxable year, and

(ii) The term "tax" as used in section 6655(d)(3) shall be defined by reference to section 6655(f) without regard to section 6655(f)(1) (B) and (C) (that is, without regard to the alternative minimum tax imposed by section 55 or the environmental tax imposed by section 59A).

(2) *Special rules for determining taxable income for preceding year.* For purposes of paragraph (b)(1)(i) of this section, the taxable income shown on the return of the corporation for its preceding taxable year shall be—

(i) Adjusted to eliminate any net operating loss deduction taken into account in that preceding year, and

(ii) Annualized, if that preceding year was of less than 12 months.

(3) *Credits taken into account*—(i) *In general.* In computing the amount of an installment payment under paragraph (b)(1) of this section, the corporation may take into account any credits against tax that are permitted to be taken into account under section 6655(d)(3) for the current taxable year.

(ii) *Foreign tax credit.* For purposes of paragraph (b)(3)(i) of this section, the amount of foreign tax credit that is permitted to be taken into account for the current taxable year is equal to the foreign tax credit allowed for the preceding taxable year multiplied by the fraction specified in the following sentence. The numerator of the fraction is the highest tax rate applicable for the taxable year under section 11, as adjusted under section 15, and the denominator is 46 percent. This alternative computation of the foreign tax credit is applicable only for purposes of computing a safe harbor installment payment under paragraph (b) of this section and cannot be applied for other estimated tax purposes.

(4) *Net operating loss carryover.* A corporation that has a net operating loss carryover as of the first day of the taxable year for which the estimated tax is being paid may use that carryover to reduce the annualized taxable income referred to in paragraph (b)(1)(i) of this section. For example, if a corporation with a net operating loss carryover of $3,000 had taxable income of $10,000 in 1986, it may use the carryover to reduce its annualized taxable income to $9,000, (($10,000 × 120%) − 3,000).

(c) *Corporation must bring aggregate payments to required level through timely subsequent installment*—(1) *In general.* A corporation using the safe harbor provided by paragraph (b) of this section shall make a timely subsequent installment payment of estimated tax in an amount sufficient to satisfy the requirements of either paragraph (c)(3) or paragraph (c)(4) of this section.

(2) *Applicable percentage.* For purposes of this paragraph (c), the applicable percentage is—

(i) 45 percent (50 percent × 90 percent), if the subsequent installment payment is the second installment payment for the taxable year, or

(ii) 67.5 percent (75 percent × 90 percent), if the subsequent installment payment is the third installment payment for the taxable year.

(3) *Annualization exception.* The subsequent installment payment of a corporation satisfies the requirements of this paragraph (c)(3) if the amount of the payment is sufficient to satisfy the requirements of section 6655(d)(3) with respect to all applicable taxes specified in section 6655(f). Thus, the corporation must determine its annualized taxable income under section 6655(d)(3)(A) (ii) or (iii), whichever is applicable, and compute the resulting tax. The resulting

tax shall include the alternative minimum tax under section 55 and the environmental tax under section 59A and may take credits into account to the extent permitted under section 6655(d)(3). The sum of this subsequent installment payment and the earlier installment payment or payments of the corporation must equal or exceed the applicable percentage of the tax so computed. In determining whether the corporation has satisfied the requirements of section 6655(d)(3)(A) (ii) or (iii) with respect to the subsequent installment, the safe harbor provided in paragraph (b)(1) of this section shall not apply.

(4) *Installment payments equal to applicable percentage of tax shown on return.* The subsequent installment payment of a corporation satisfies the requirement of this paragraph (c)(4) if the sum of that payment and the earlier installment payment or payments of the corporation equals or exceeds the applicable percentage of the tax shown on the return of the corporation for the taxable year to which the installment payments relate. The tax shown on the return includes all taxes specified in section 6655(f).

(5) *Consequence of corporation's failure to satisfy requirements for subsequent installment*—(i) *In general.* If a corporation fails to satisfy the requirements set out in this paragraph (c), the corporation shall lose the benefit of the safe harbor provided by paragraph (b)(1) of this section.

(ii) *Limit on penalty.* The aggregate underpayment penalty with respect to any installment payment or payments for which a corporation loses the benefit of the safe harbor under paragraph (c)(5)(i) of this section shall be limited to the "shortfall penalty amount." The shortfall penalty amount is the penalty that would be imposed under section 6655(a) if there were an underpayment of the subsequent installment payment equal to the excess of—

(A) The amount required to be paid, as determined under this paragraph (c), on or before the due date of the subsequent installment payment, over

(B) The amount actually paid on or before such date with respect to the subsequent installment payment.

For purposes of this determination, the period of the underpayment shall run from the due date of the subsequent installment payment until the earlier of the dates specified in section 6655(c) (1) or (2).

(iii) *Example.* The provisions of this paragraph (c)(5) may be illustrated by the following example:

Example. Corporation M, which uses the calendar year as its taxable year, relies on the safe harbor provided by paragraph (b) of this section for its first two installment payments of estimated tax for 1987. M is required by this paragraph (c) to make a timely subsequent installment payment of $1,000,000 by September 15, 1987, but M's actual installment payment by that date is only $990,000. Because of this shortfall, M loses the benefit of the safe harbor and is subject to underpayment penalties with respect to the first two installments. The aggregate penalties with respect to those two installments, however, cannot exceed the amount of the underpayment penalty to which M would be subject if there were an underpayment of $10,000 with respect to the September 15, 1987, installment payment. Such penalties are independent of any penalty that may apply with respect to M's third installment payment under the normal rules of section 6655.

(d) *Example.* The provisions of this section may be illustrated by the following example:

Example. (i) Corporation X (which is not a life insurance company) uses as its taxable year a fiscal year ending on January 31 and is required to pay an installment of estimated income tax by May 15, 1987, for its taxable year beginning on February 1, 1987. On its return for the taxable year ending January 31, 1987, which was a year of 12 months, X reported taxable income of $10,000,000 ($9,000,000 of which was ordinary income and $1,000,000 of which was net capital gain) and did not claim any net operating loss deduction. As of February 1, 1987, X has no net operating loss carryforwards and no credit carryforwards. X has no credits against tax that are permitted to be taken into account under section 6655(d)(3) for 1987. If X uses the safe harbor provided in paragraph (b)(1) of this section, X must make by May 15, 1987, an installment payment of estimated tax of at least $1,037,836, computed as follows:

(1) Taxable income shown on return for taxable year ending on January 31, 1987	$10,000,000
(2) Annualized taxable income for taxable year ending January 31, 1988, determined pursuant to paragraph (b)(1) of this section (Item (1)x120%)	$12,000,000
(Note: 120%xordinary income of $9,000,000=$10,800,000; 120%xnet capital gain of $1,000,000=$1,200,000)	
(3) Tax on annualized taxable income (Item 2) using rates under section 11 and 1201, taking into account section 15, applicable to the taxable year ending January 31, 1988	$4,612,603
(4) Amount described in section 6655(d)(3)(A)(i) (Item (3)x22.5%)	$1,037,836

(ii) To preclude imposition of an addition to tax under section 6655 with respect to its May 15, 1987, installment payment, X must make by July 15, 1987, a second installment payment of estimated tax sufficient to bring its aggregate payments to the minimum level required under paragraph (c) of this section.

(iii) X may satisfy the requirements of paragraph (c)(3) of this section by making a second installment payment sufficient to bring X within the exception provided in section 6655(d)(3). Thus, if X determines under that section that the aggregate of X's installment payments of estimated tax by July 15, 1987, must equal at least $3,000,000, X may obtain the benefit of the safe harbor provided in paragraph (b)(1) of this section with respect to the May 15, 1987, installment payment by making a timely second installment payment of $1,962,164 ($3,000,000—$1,037,836).

(iv) Even if X fails to satisfy the requirements of paragraph (c)(3) of this section, X may obtain the benefit of the safe harbor for the May 15, 1987, installment payment if X's second installment payment, when aggregated with the first payment, equals at least 45 percent of the tax (including the alternative minimum tax under section 55 and the environmental tax under section 59A) shown on X's return for X's taxable year beginning on February 1, 1987. Thus, if the tax shown on that return is $6,000,000, X's second installment payment under paragraph (c)(4) of this section must be at least $1,662,164, computed as follows:

45 percent of $6,000,000	$2,700,000
less first payment	1,037,836
Minimum second installment	$1,662,164

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

Approved: March 24, 1987.

J. Roger Mentz,

Assistant Secretary of the Treasury.

[FR Doc. 87-6719 Filed 3-24-87; 3:17 pm]

BILLING CODE 4830-01-M

26 CFR Parts 1 and 602

[T.D. 8131]

Income tax, Capitalization and Inclusion in Inventory of Certain Costs

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary Regulations.

SUMMARY: This document contains temporary regulations relating to accounting for costs incurred in producing and acquiring property for resale. In addition, the text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the Notice of Proposed Rulemaking in the proposed rules section of this issue of the **Federal Register**. Changes to the applicable tax law were made by the Tax Reform Act of 1986.

DATES: The amendments are effective for costs incurred after December 31, 1986 or, in the case of inventories, for taxable years beginning after December 31, 1986.

FOR FURTHER INFORMATION CONTACT: Paulette C. Galanko of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224 (Attention: CC:LR:T), (202) 566–3288, not a toll-free call.

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) under sections 174, 263, 263A, 446, 471, and 1502 of the Internal Revenue Code of 1986. These amendments conform the regulations to the requirements of section 803 of the Tax Reform Act of 1986 (Pub. L. 99–514), 100 Stat. 2085 (the "Act"). The temporary regulations contained in this document will remain in effect until additional temporary or final regulations are published in the **Federal Register**.

Uniform Costing Rules

Under prior law, the type and amount of costs required to be absorbed or capitalized by taxpayers engaged in the production of property were determined under various sections of the Internal Revenue Code and regulations. As a result, different rules applied to the costs incurred in the production of property depending on the type of property produced and the intended use of the property in connection with the taxpayer's activities. In some cases, costs incurred in producing property were permitted to be deducted currently, rather than being properly matched with the future income associated with that property. Thus, for example, production costs were permitted to be deducted currently, rather than being recovered when the related property was sold or used in the course of the taxpayer's trade or business. Similarly, costs incurred in the acquiring, handling, and storage of property (including property acquired by the taxpayer for resale to others) were frequently allowed to be deducted currently rather than being properly matched with the appropriate income.

In response to this disparity in treatment, section 263A was added to the Code to provide a uniform set of rules to be applied in determining the costs required to be capitalized or included in inventory costs. (For purposes of this preamble and the regulations, the term "capitalize" shall, except as provided to the contrary, denote the capitalization of costs, i.e., the charging of costs to capital account or basis, as well as the addition or absorption of costs to items of inventory). Except as provided, these rules apply to all costs incurred in connection with the production of real and personal tangible property to be held in inventory or held for sale in the ordinary course of business. The rules also apply to the production of other property, including property or improvements to property constructed by a taxpayer for use in its trade or business or in an activity engaged in for profit. Finally, in the case of property acquired for resale, these rules generally apply to costs incurred for the storage, purchase, repackaging or processing of such property, including an allocable amount of general and administrative costs.

Treatment of Certain Costs

The temporary regulations do not apply to intangible drilling and development costs of oil and gas or geothermal wells allowable as a deduction under section 263(c) or development costs of mineral properties allowable as a deduction under sections 616(a) and 617(a) of the Code.

Similarly, the temporary regulations generally do not apply to property produced by a taxpayer pursuant to a long-term contract. Section 460 of the Code, enacted into law under section 804 of the Act, determines the federal income tax treatment of long-term contracts. Nevertheless, these temporary regulations provide guidance with respect to two aspects of the treatment of long-term contracts. First section 460(c)(3) of the Code provides that production interest shall be allocated to long-term contracts in the same manner as interest is allocated to property produced by the taxpayer under section 263A(f). Second, these regulations apply to costs incurred by a taxpayer (*e.g.*, interest and administrative costs), with respect to property produced by a contractor for the taxpayer under a long-term contract.

Section 263A does not apply to the growing of timber as defined under prior law. For this purpose, the definition of timber includes evergreen trees that are more than six years old when severed from the roots (whether or not such trees are sold for ornamental purposes). In the case of timber, the law in effect prior to the enactment of section 263A is to continue to apply with respect to the determination of the costs that are to be treated as deductible and those that are required to be charged to capital accounts.

Interest

Interest expense paid or incurred in the course of production is included in the costs required to be capitalized under section 263A. The temporary regulations contain general rules relating to the allocation of interest with respect to production activities under the "avoided cost" concept. Detailed regulations relating specifically to the allocation of interest expense under section 263A will be issued in a separate document.

Tangible and Intangible Property

In the case of production activities, the rules contained in the temporary regulations apply to costs allocable to the production of real and tangible personal property. With respect to costs incurred in connection with property acquired for resale, the rules apply to both tangible and intangible property. (For example, the rules contained in the temporary regulations apply to persons acquiring securities or commodity contracts described in section 1221(1) for resale to others). For purposes of these regulations, films, recordings, video tapes, books and other similar property are treated as tangible personal property, and thus are subject to the capitalization rules regarding production of tangible personal property. These regulations are not intended to provide guidance (under prior or present law) as to whether the subject matter of a particular production activity is to be treated as a tangible or intangible asset for other purposes of the Code.

Under the new rules, the costs of producing films, recordings, video tapes, books, and other similar property must be capitalized under the provisions of section 263A. For example, as the legislative history to the Act provides, "the uniform capitalization rules apply to the costs of producing a motion picture or researching and writing a book." 2 H.R. Rep. No. 99–841 (Conf. Rep.), 99th Cong., 2d Sess. II–308, n. 1 (1986) (the "Conference Report"). The capitalization requirements of section

263A apply to these properties regardless of whether the costs of these properties are treated as intangible or tangible costs under other provisions of the Code (*e.g.*, the provisions regarding the availability of investment tax credit). Thus, for example, the costs of producing a book (including teaching aids, and other similar properties) which are required to be capitalized under section 263A include, without limitation, prepublication expenditures of publishers, such as payments made to the authors of literary works, as well as costs incurred by the publishers in the writing, editing, compiling, illustrating, designing, and development of books or similar property. Such costs are to be capitalized under section 263A regardless of whether such costs relate to the production of the manuscript or copyright of a book, as opposed to the physical costs (*e.g.*, paper and ink) of printing and binding a book. Moreover, although research and experimental expenditures within the meaning of section 174 are not subject to the capitalization rules of section 263A, capitalization of prepublication expenditures with respect to books and similar properties is consistent with the definition of research and experimental expenditures in the existing regulations under section 174. See § 1.174–2(a)(1) of the Income Tax Regulations, which provides that the term "research and experimental expenditures" does not include expenditures incurred for research in connection with literary, historical, or similar projects.

Section 2119 of the Tax Reform Act of 1976 (Pub. L. 94–455) (the "1976 Act") provides that any regulations issued after the date of enactment of such Act dealing with the application of various Code sections (including sections 174 and 263) to prepublication expenditures "shall apply only with respect to taxable years beginning after the date on which such regulations are issued". Section 2119 of the 1976 Act (90 Stat. 1912) was not amended in the Tax Reform Act of 1986 to expand this restriction on effective dates to include regulations applying 263A. Moreover, in enacting section 263A of the Code, Congress simultaneously repealed section 280 of the Code, which dealt with expenditures incurred by individuals and certain entities in the production of books and other properties. The repeal of section 280, the legislative history to section 263A applying the provisions of section 263A to the costs of "researching and writing a book," and the statutory requirement to capitalize the costs of producing books as if they were tangible property, clearly evidence an intent to: (i) Apply the uniform capitalization rules of section 263A to the costs of producing books (indicating that such costs are not allowable as a deduction under section 174 because section 263A is not applicable to such deductions); and (ii) expand the persons subject to these capitalization rules beyond the range of section 280 which only applied to individuals and certain entities.

If, and to the extent, that section 2119 of the 1976 Act would otherwise contravene the clear Congressional intent underlying section 263A of the Tax Reform Act of 1986 regarding the production of books, then section 263A, the more recent expression of Congressional intent, is properly viewed as the legally determinative provision and section 2119 is viewed as modified, accordingly.

Thus, based on the foregoing, section 263A is applicable to all prepublication expenditures with respect to costs incurred after December 31, 1986, in taxable years ending after such date. If such prepublication expenditures relate or pertain to inventory property, section 263A shall apply to taxable years beginning after December 31, 1986, and shall require a change in method of accounting necessitating, for example, an adjustment under section 481.

Separate Trade or Business

Under the regulations, taxpayers may elect the use of various simplified methods and other procedures with respect to each trade or business of the taxpayer. The regulations clarify that, for purposes of these provisions, activities of the taxpayer shall not constitute a separate trade or business solely by reason of classification as a "natural business unit" or a similar inventory pool.

Gross Receipts Exception

The new capitalization rules for personal property acquired for resale do not apply if the taxpayer's average annual gross receipts for the three preceding taxable years are $10 million or less. This $10 million threshold test is not available with respect to real property acquired by the taxpayer for resale. The rules in effect before the enactment of section 263A to the Code continue to apply to taxpayers with average annual gross receipts of $10 million or less. Aggregation rules to take into account the gross receipts of certain related parties are provided for purposes of this provision.

Property Acquired for Resale

Taxpayers acquiring real or personal property for resale are subject to the provisions of section 263A. Taxpayers acquiring such property may elect a simplified method of accounting for the costs required to be capitalized under the temporary regulations (the "simplified resale method"). The allocation rules applicable to production activities will apply to those taxpayers that acquire property for resale who do not elect to use the simplified resale method. Thus, absent the election of the simplified resale method, taxpayers acquiring property for resale are required to allocate the additional costs required to be capitalized under section 263A with the same degree of specificity as was required of manufacturers of inventory under prior law. The regulations provide, however, that such taxpayers are generally required to allocate the same types of costs (*e.g.*, costs pertaining to purchasing, handling, storage, and allocable general and administrative activities) to property acquired for resale as taxpayers electing to use the simplified resale method. Moreover, the definitions of such costs under the simplified resale method are equally applicable to taxpayers acquiring property for resale although those taxpayers may not elect the use of such method. (In addition, pursuant to the legislative history of the Act, the regulations clarify that taxpayers producing property must also capitalize purchasing, handling and storage costs under section 263A).

The costs required to be allocated to property acquired for resale under the simplified resale method relate to the costs incurred in connection with purchasing ("purchasing"), handling, processing and repackaging ("handling"), and offsite storage and warehousing ("storage") of such property. In addition, such costs include the general and administrative costs allocable to these functions. The temporary regulations provide guidelines for determining what costs are incurred in connection with these activities and the methods by which such costs are to be allocated to the property acquired and held. The temporary regulations contain examples that apply the simplified resale method to inventories in cases involving the use of both the last-in first-out ("LIFO") and the first-in first-out ("FIFO") methods.

The simplified resale method as set forth in the temporary regulations generally follows the simplified method described in the legislative history of the Act (Conference Report at II 305–08). However, the simplified resale method differs from the simplified method set forth in the Conference Report in two minor respects. The differences between the two methods concern: (i) The inclusion of beginning inventory balances in determining certain allocation ratios under the simplified method; and (ii) the allocation ratio used to apportion general and administrative expenses.

The simplified method set forth in the Conference Report provides that the allocation ratio for apportioning storage costs and handling costs shall be determined by dividing: (i) The amount of such costs, by (ii) beginning inventory balances and gross purchases during the year. The simplified resale method as set forth in the temporary regulations provides that the denominator of the fraction, as described above, shall consist only of gross purchases during the year. Beginning inventory balances are excluded from the calculation of the allocation ratio in the simplified resale method.

This change has been made to provide consistency with the treatment of beginning inventory balances under the simplified resale method. Under both versions of the method, storage and handling costs incurred during the year are only allocated to units in ending inventory which are not viewed as being present in beginning inventory for the year in question. Thus, for example, with respect to a LIFO taxpayer, such costs are allocated to units in the LIFO "increment" for such year. Similarly, with respect to a FIFO taxpayer, such costs are allocated only to the extent that units in ending inventory are treated as being purchased during the year under the FIFO cost flow assumption. Inclusion of beginning inventory balances in the denominator of the allocation fraction would be justified only if storage and handling costs were viewed as benefitting, and being incurred by reason of, units in beginning inventory. However, such a view is inconsistent with the determination that beginning inventory balances do not accumulate accretions of annual storage and handling costs. Accordingly, the simplified resale method differs from the simplified method in the Conference Report with respect to the determination of these allocation ratios.

The simplified resale method also differs from the method provided in the Conference Report with regard to the allocation of general and administrative expenses that are allocable in part to storage, purchasing, and handling activities, and in part to activities for which capitalization is not required under the simplified method ("mixed service costs"). The Conference Report provides that mixed service costs shall be allocated to activities based on the ratio of payroll costs incurred in a particular function divided by the taxpayer's total gross payroll costs. This procedure requires the denominator of the allocation fraction to include payroll costs which are themselves mixed service costs. The inclusion of mixed service costs in the denominator would imply that costs qualifying as mixed service costs are being allocated, in part, to such mixed service costs themselves. Such a result would only be appropriate if such amounts initially allocated were eventually reallocated to either activities subject, or not subject, to capitalization. However, the mechanics of the simplified method in the Conference Report do not provide for any such reallocation procedure, but rather only require an initial allocation of service costs to the activities of the taxpayer. Based on the foregoing, the simplified resale method provides that the labor costs of mixed service functions are subtracted from the denominator of the allocation fraction which is used to determine the amount of mixed service costs allocable to activities subject to capitalization. In addition, the simplified resale method contains a "de minimis" rule to be used in determining whether the cost of a particular activity is a mixed service cost under the regulations.

The Conference Report provides that "the simplified method provided under rules or regulations generally will follow the examples . . . [contained in the Conference Report] and that, until rules or regulations are issued, taxpayers may rely on these examples." Conference Report at II-305. Additionally, the Conference Report provides, that "[t]he Treasury Department may modify the simplified method or permit the use of other methods by rules or regulations". The changes made to the simplified method in the temporary regulations are changes of a technical and minor nature that do not alter the general mechanics of the method or the simplifying assumptions underlying its use. In light of the publication of these temporary regulations, taxpayers electing to use the simplified method for property acquired for resale are required to use the simplified resale method as provided herein in determining their taxable income for their taxable years beginning after December 31, 1986, and in determining their estimated tax payments for all periods in such years. The election to use the simplified resale method shall be made separately with respect to each trade or business of the taxpayer.

Inventories

For taxable years beginning after December 31, 1986, the temporary regulations require a restatement or revaluation of beginning inventory balances to reflect the additional amounts required to be included in inventory costs under the uniform capitalization rules. Goods on hand as of the effective date are to be revalued as if the new capitalization rules had been in effect for all prior periods; such revaluation is treated as a change in the taxpayer's methods of accounting for inventory costs. For taxpayers using the "dollar-value" LIFO method of valuing inventories, the revalued year prior to the year of change will become the new base year for purposes of determining future indexes.

For taxpayers required to change their method of accounting under the temporary regulations, sufficient data required to make an accurate revaluation of all costs or layers in a taxpayer's inventory may be unavailable or difficult to obtain. For example, in cases where goods held in inventory are no longer produced by the taxpayer or the taxpayer is treated as having acquired or produced an item of inventory a number of years prior to the date of revaluation, the taxpayer may not have the information necessary to compute the actual amount of additional costs allocable to such inventory items. For this reason, the temporary regulations provide rules that permit certain taxpayers to estimate the costs to be used in the revaluation of inventory costs or layers that relate to prior periods.

With respect to LIFO taxpayers required to account for the costs of producing inventory or acquiring property for resale under section 263A, it is intended that the provisions of prior law be continued with respect to the circumstances whereunder a LIFO election may be disallowed or terminated. Thus, for example, in determining inventory cost for the year of a LIFO election and any subsequent year, the failure to include (or exclude) an item of cost as required by section 263A will not warrant disallowance or termination of a LIFO election. (See Revenue Procedure 79–23, 1979–1 C.B. 564). Similarly, it is intended that the allocation of costs under section 263A shall not result in a violation of the "LIFO conformity requirement" in § 1.472–2 of the Income Tax Regulations in situations where a similar allocation of production costs under § 1.471–11 of the Income Tax Regulations (the "full absorption" regulations) would not result in any such violation.

Simplified Production Method

Taxpayers producing inventory property may elect a simplified method of accounting for the costs required to be allocated under the temporary regulations (the "simplified production method"). Absent the election of the simplified production method, taxpayers are required to allocate additional costs required to be capitalized under section 263A with the same degree of specificity as was required of inventoriable costs under prior law. The simplified production method shall be treated as a method of accounting under the Code. Once a taxpayer has chosen either the simplified production method, or the methods generally available to producers of property under the Code, such taxpayer may not change its method without obtaining the permission of the Commissioner.

The simplified production method is similar to the simplified resale method available to taxpayers acquiring property for resale. Under the simplified production method, a taxpayer shall determine all of the additional costs (other than interest expense) which are required to be included by the taxpayer in inventoriable costs for the year under section 263A and the regulations (the "additional section 263A costs"). (Interest, however, shall be excluded from the additional section 263A costs under the simplified production method and allocated separately). The amount of the additional selection 263A costs shall vary with respect to each taxpayer, depending on the amount and types of costs that such taxpayer included in the computation of inventoriable costs under prior law. The additional section 263A costs shall then be allocated to inventory based on the ratio (the "absorption ratio") of such costs to the taxpayer's total "section 471 costs" incurred for the year under the taxpayer's method of accounting. The taxpayer's "section 471 costs" are defined as the costs required to be included in inventoriable costs by the taxpayer under the full absorption regulations. The taxpayer shall determine the additional section 263A costs to be allocated to ending inventory by multiplying the absorption ratio by the amounts contained in the taxpayer's ending section 471 inventory balance which are treated as costs incurred during the current year under the taxpayer's method of accounting. The taxpayer's "section 471 inventory balance" is defined as the inventory balance of the taxpayer's section 471 costs at the specified point in time. The temporary regulations contain examples which provide guidance to taxpayers regarding the application of the simplified production method.

For purposes of the simplified production method, taxpayers will initially calculate their inventory balances without regard to the new uniform capitalization rules. Taxpayers will then determine the amounts of additional section 263A costs that must be capitalized, and add such amounts, along with amounts of additional section 263A costs contained in beginning inventory balances (where appropriate), to their preliminary inventory balances to determine their final balances. Thus, for example, with respect to a taxpayer using the LIFO method, the calculation of a particular year's LIFO index will be made without regard to the new capitalization rules. However, costs capitalized under the simplified production method will be added to the LIFO layers applicable to the various years for which the costs were accumulated. Although the additional section 263A costs are not included with the taxpayer's section 471 costs in calculating a particular year's LIFO index, the additional section 263A costs shall be treated as inventory costs for all purposes of the Code. Thus, for example, with respect to a FIFO taxpayer which properly elects to value its inventory at the lower of cost or market (as described in § 1.471-2(c) of the Income Tax Regulations), the additional section 263A costs which are applicable to the taxpayer's section 471 costs shall be treated as costs of inventory for purposes of determining: (i) Whether the cost of inventory exceeds its market value; and (ii) the amount of the reduction in the inventory cost which is allowed under the regulations to value the inventory at market.

The determination by a taxpayer of its section 471 costs under the simplified production method shall be made by reference to the methods of accounting used by such taxpayer immediately prior to the effective date of the Act. Any change in the determination of section 471 costs which would constitute a change in method of accounting under law prior to the Act shall be deemed to constitute a change in method of accounting under section 263A, and is thus subject to all requirements of law regarding such change.

Taxpayers may elect to use the simplified production method with respect to the production of inventory property. In addition, taxpayers may elect to use the simplified production method with respect to production of property which is held primarily for sale to customers in the ordinary course of the taxpayer's business, although that property may not qualify as inventory property under the Code (*e.g.*, houses constructed by a builder and offered for sale to customers). With respect to a taxpayer eligible to use the simplified production method, but which properly does not account for its production costs under the full absorption regulations, the term "section 471 costs" as used above, shall be defined as the costs required to be allocated to production under the taxpayer's method of accounting immediately prior to the effective date of the Act.

The simplified production method is 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. Such a production process is especially amenable to the simplified production method, which essentially allows allocation of additional section 263A costs to the aggregate inventory balances of the taxpayer based on the aggregate "turnover" rate of the taxpayer's inventory. Based on the foregoing, the simplified production method is not appropriate for use in accounting for casual or occasional production of property. Thus, the simplified production method may not be utilized with respect to property constructed by a taxpayer for use in its trade or business ("self-constructed" property), or any other property produced by a taxpayer which is not described in section 1221(1). Similarly, the simplified production method is not available with respect to property produced under a long-term contract even though an inventory method may be used by the taxpayer to account for such production. Finally, the simplified production method is not available to taxpayers acquiring property for resale who do not elect to use the simplified resale method, and thus are required to use the general rules applicable to the production of property.

In the case of a single trade or business that consists of operations including both the production of property and the acquisition of property for resale, the simplified production method, if elected, must be applied with respect to all operations of that trade or business. In such a case, a taxpayer is not permitted to apply the simplified production method to only a portion of the operations of such trade or business; moreover, the taxpayer may not apply the simplified resale method to any portion of such trade or business.

The election to use the simplified production method shall be made separately with respect to each trade or business of the taxpayer.

The temporary regulations provide a simplified method for producers of property in order to reduce the administrative costs of taxpayer compliance with the capitalization requirements of section 263A while preserving the statute's basic purpose to apply uniform capitalization rules to the costs of producing property. The Internal Revenue Service welcomes comments and suggestions as to how the simplified production method may be improved to accomplish objectives most adequately.

General and Administrative Expenses—Simplified Method

The temporary regulations also provide a simplified procedure (the "simplified service cost method") for determining the amount of certain indirect costs which are required to be allocated by the taxpayer to inventory production under section 263A. The simplified service cost method shall be treated as a method of accounting under the Code. Once a taxpayer has chosen either the simplified service cost method, or other methods available for allocating such costs, such taxpayer may not change its method of accounting without obtaining the permission of the Commissioner. The simplified service cost method shall only be used to determine the total amount of certain indirect costs which are required to be allocated to inventory production under section 263A ("inventoriable mixed service costs"). The allocation of such indirect costs to particular items of inventory shall be made pursuant to other methods allowed under the temporary regulations.

The amount of inventoriable mixed service costs for a particular taxable year shall be determined by multiplying: (i) The total mixed service costs of the taxpayer incurred in the particular trade or business of such year, by (ii) the ratio of: (a) (all of the taxpayer's production costs incurred during the year excluding all mixed service costs and all interest, to (b) all of the taxpayer's costs of operations incurred during such year excluding all mixed service costs and all interest). For purposes of this procedure, all of the taxpayer's production costs incurred during the year include all of the inventoriable costs incurred in the particular trade or business as determined under section 263A and this section. Thus, for example, such costs include all of the taxpayer's section 471 costs, in addition to all of the taxpayer's additional section 263A costs.

In addition, for purposes of this procedure, all of the taxpayer's costs of operations incurred during the taxable year include all of the taxpayer's production costs incurred during the year, in addition to all of taxpayer's other costs of operations incurred in the particular trade or business. Such costs include, but are not limited to: (i) Salaries and related costs of all personnel, (ii) all depreciation taken for federal income tax purposes, (iii) research and experimental expenses, and (iv) selling, marketing and distribution expenses. Such costs of operation shall not include however, federal, state, local income taxes (or taxes similar to income taxes, e.g., franchise taxes assessed on income). The regulations contain examples which provide guidance as to the application of the simplified service cost method.

The indirect costs for which the simplified service cost method may be used are indirect general and administrative costs which directly benefit, or which are incurred by reason of the performance of the inventory production activities of the taxpayer, but which also benefit other activities of the taxpayer which are not inventory production activities. For purposes of this provision, such costs shall be defined as "mixed service costs." The simplified service cost method, however, shall not be used with respect to mixed service costs which the taxpayer is properly allocating under its method of accounting (prior to the Act) to production activities under the full absorption regulations. Such general and administrative costs are outside the scope of this provision, and shall be allocated to production activities under the general provisions of this section.

In addition, mixed service costs do not include indirect costs which directly benefit or which are incurred by reason of the production activities of the taxpayer, if such costs do not benefit other activities to any extent ("production service costs"). Moreover, mixed service costs do not include indirect costs which do not directly benefit and are not incurred by reason of the taxpayer's inventory production activities to any extent ("policy service costs").

In determining whether indirect costs shall be treated as production service costs or policy service costs, the predominant nature of the indirect costs shall be the controlling factor. For purposes of this method, the predominant nature of a indirect cost shall be viewed as attributable to a particular activity if 90% or more of that cost directly benefits, or is incurred by reason of, such activity. In such a case, the taxpayer shall disregard the portion of the cost which is attributable to the activities which are not predominant. For example, assume that 90% of the costs of a particular department directly benefit, or are incurred by reason of the taxpayer's inventory production activities. For purposes of this method, the taxpayer shall treat 100% of the costs of the department as if such costs were production service costs. Similarly, assume that 90% of the costs of a particular department directly benefit, or are incurred by reason of the taxpayer's policy making activities. For purposes of this method, the taxpayer shall treat 100% of the costs of the department as if such costs were policy service costs.

Taxpayers engaged in production of inventory may incur mixed service costs which are allocable to more than one trade or business. In such a case, the amount of mixed services costs which are allocable to the particular trade or business for which the simplified service cost method has been elected, shall be determined using any reasonable allocation method generally allowed under these regulations. Similar rules shall apply to the taxpayer's cost of operations which are incurred in more than one trade or business.

A taxpayer may elect to use the simplified service cost method regardless of whether such taxpayer elects to use the simplified production method. Thus, for example, a taxpayer may determine its inventoriable mixed costs under the simplified service cost method, and then allocate such mixed service costs to its production activities under the general provisions of the regulations. In such a situation, the taxpayer shall allocate inventoriable mixed service costs based on any reasonable allocation procedure allowed under the regulations. In the case of a taxpayer that elects to use the simplified production method and also elects to use the simplified mixed service cost method, the amount of inventoriable mixed service costs shall be included with the additional section 263A costs, and allocated to ending inventory based on the procedures required under the simplified production method. Taxpayers may elect to use the simplified service cost method only with respect to production of the same types of property for which an election may be made to use the simplified production cost method, *i.e.*, inventory property and property held primarily for sale to customers in the ordinary course of business.

The election to use the simplified service cost method shall be made separately with respect to each trade or business of the taxpayer.

Farming Businesses

The provisions of the temporary regulations also apply to property produced in a farming business. In general, the temporary regulations apply to costs allocable to the production of property with a "preproductive period" that exceeds two years. Taxpayers required to use an accrual method of accounting under sections 447 and 448(a)(3), however, must allocate costs under section 263A and the temporary regulations without regard to the preproductive period of the property produced. The temporary regulations permit the use of the farm-price method and the unit-livestock-price method ("unit-livestock method") in accounting for the costs allocable to property produced in a farming business. A special rule, described below, is provided for tax shelters using the unit-livestock method.

Under the unit-livestock method as currently applied under § 1.471–6 of the Income Tax Regulations, no increase in unit cost is required in the taxable year of purchase of certain animals which are purchased during the last six months of such taxable year. As a result, in some cases the use of the method may not result in an adequate allocation of costs consistent with the principles of section 263A, particularly in the case of tax shelters where anticipated tax consequences are likely to play a significant role in the determination of when to purchase livestock.

Thus, the temporary regulations provide that tax shelters using the unit-livestock method of accounting must include in inventory the annual cost increment for all animals purchased during the taxable year, including those purchased during the last six months of the taxable year. For purposes of this provision, the term "tax shelter" is defined as any tax shelter required to use an accrual method of accounting under section 448(a)(3).

Section 263A(d)(3) allows certain taxpayers to elect not to have the provisions of section 263A apply to any plant or animal produced in any farming business carried on by such taxpayer. The election procedures are described in detail in the temporary regulations relating to elections under the Tax Reform Act of 1986 (§ 5h.5(c) of the Income Tax Regulations). In addition, the temporary regulations under section 263A herein provide guidance with respect to various features of the election, including the determination of eligibility for the election, and the effect of such election of the farming businesses of the taxpayer.

Under the election procedures, taxpayers may elect to account for farming production costs under the rules in effect before the enactment of section 263A subject to certain conditions relating to the cost recovery of property used in any farming business of the taxpayer and the treatment upon disposition of the property being produced in the business. The election not to have section 263A apply is effective as to all the farming activities of the electing taxpayer.

Section 263A does not apply to costs incurred on or after October 22, 1986, by certain taxpayers for replanting edible crops lost or damaged by reason of various types of casualty. The temporary regulations provide guidance with respect to this provision. Persons, other than the taxpayer that owned the property at the time of loss or damage, are permitted to deduct costs of replanting if certain ownership and participation criteria are met.

Practical Capacity

Under § 1.471–11(d)(4) of the full absorption regulations applicable to manufacturers of inventory under prior law, taxpayers were permitted to use the "practical capacity concept" in determining the amounts of fixed indirect production costs which were subject to inclusion in ending inventory. Under the practical capacity concept, taxpayers were required to apportion only a percentage of their fixed indirect production costs to units of production; this percentage corresponded to the percentage of productive capacity at which the particular manufacturing facility was operating. The remaining amounts of fixed indirect production costs were then currently deducted by the taxpayer.

The temporary regulations do not provide guidance with respect to the availability of the practical capacity concept under the uniform capitalization rules of section 263A. The Internal Revenue Service is considering this issue and will provide future guidance with respect to the practical capacity concept under section 263A. It is possible that the forthcoming regulations will prohibit the use of the practical capacity concept under section 263A, subject to the effective date provisions of section 803 (d)(2) of the Act generally applicable to inventory property.

The fact that these temporary regulations provide no guidance with respect to the practical capacity concept under section 263A creates no inference as to the availability of the concept in accounting for costs under a long-term contract under sections 451 or 460 of the Code.

Pension Costs—Past Service Costs

Under the temporary regulations, contributions paid to or under a pension or annuity plan which are allowable under section 404 (and section 404A if applicable), are not subject to the capitalization requirements of section 263A to the extent that such contributions represent "past service costs". Until otherwise provided to the contrary, past service costs shall be determined, for purposes of section 263A, with reference to the allocation between "normal costs" and "past service costs" under the funding standards of section 412. With respect to an actuarial method which does not distinguish between normal costs and past service costs, none of the amount allowable as a deduction under section 404 shall be treated as past service costs.

The legislative history of the Act evidences a Congressional concern with the utilization of the funding standards under section 412 in determining the nature of pension costs for purposes of section 263A. (*See* S. Rep. No. 99–313, 99th Cong., 2d Sess. at 142–43 (1986)). Accordingly, the Internal Revenue Service is presently considering this matter, and may revise, at some future date, the regulations under section 263A defining past service costs for purposes of the uniform capitalization rules. Alternative provisions under consideration include the utilization, in whole or in part, of financial reporting standards in determining past service costs. Any amendments to these regulations which alter the determination of past service costs under section 263A will be applied in a prospective manner, i.e., with respect to costs incurred after the publication of such amendments (or, in the case of inventory property, with respect to taxable years beginning after the publication of such amendments).

Allocation Methods

In accordance with the legislative history of the Act, the temporary regulations provide cost capitalization rules that are consistent with the rules contained in § 1.451–3 of the Income Tax Regulations and permit the use of cost allocation methods similar to those described in §§ 1.451–3 and 1.471–11 of the regulations. In general, the temporary regulations provide that indirect costs are to be allocated to property using methods that result in a reasonable allocation of costs to and among activities, including the specific identification method, the standard cost method, and methods using burden rates. Allocations of administrative, service, or support costs that benefit or are incurred by reason of an activity are to be made on the basis of a factor or relationship that reasonably relates such costs with the benefit provided to the activity. The temporary regulations permit the use of any reasonable method of allocating general and administrative costs that is consistently applied.

Allocations Between Related Parties

The temporary regulations provide guidance with respect to the providing of any good or service ("item") between related parties if such item is required to be capitalized by the recipient taxpayer under section 263A and if such item is provided at a price which is less than an "arm's length" charge. The temporary regulations require that both the taxpayer and the related person account for the transaction as if the taxpayer purchased the item in question for its arm's length charge from the related person. Thus, for example, the taxpayer would capitalize an amount equal to the arm's length charge for the item, and the related person would typically include in income an amount equal to such arm's length charge.

The temporary regulations provide exceptions to the required accounting treatment of these transactions in situations where the principles of section 263A would not be contravened by the accounting treatment used by the taxpayer and the related person.

For purposes of this provision, the term "related persons" shall mean two or more organizations, trades, or businesses, owned or controlled directly by the same interests, within the meaning of section 482. The rules under section 482 shall apply in determining the arm's length charge of an item, and the various correlative adjustments which shall occur by virtue of the required accounting treatment of these transactions. The Internal Revenue Service invites comments with respect to this provision.

Substantial Construction

In general, the rules contained in the temporary regulations apply to costs incurred after December 31, 1986. These rules do not apply, however, to costs incurred in connection with property constructed by the taxpayer for use in its trade or business if substantial construction had occurred with respect to the property before March 1, 1986.

The temporary regulations provide that, for purposes of section 263A, substantial construction will be deemed to have occurred if the lesser of: (i) 10 percent of the total estimated costs of construction, or (ii) (the greater of $10 million or 2 percent of the total estimated costs of construction), was incurred before March 1, 1986. The temporary regulations provide an example to illustrate the application of this rule. For purposes of this rule, construction costs are those costs incurred during the actual physical construction of the property. Costs incurred for preliminary activities such as project engineering and architectural design activities, do not constitute costs incurred for construction.

Natural Gas

Pursuant to the legislative history of the Act, the temporary regulations provide that the provisions of section 263A regarding the capitalization of indirect costs with respect to property acquired by the taxpayer for resale shall not apply to "cushion gas." For this purpose, cushion gas is defined as natural gas stored in an underground storage facility or reservoir which is necessary to maintain the level of pressure within such reservoir to allow for its operation. (Cushion gas which is not recoverable upon the abandonment or termination of the storage facility is a capital expenditure recoverable through depreciation. Revenue Ruling 75–233, 1975–1 C.B. 95.) No inference is intended by this exception of cushion gas from the capitalization rules of section 263A as to the federal income tax treatment of other matters (*e.g.*, the treatment of "line pack gas" contained within a natural gas pipeline). Similarly, the exception for cushion gas from the capitalization rules of section 263A does not affect the treatment of cushion gas under other sections of the Code, where applicable.

The legislative history of the Act also provides that the Treasury Department "may" issue regulations providing that "emergency gas" (or a portion thereof), may be similarly excepted from the capitalization rules of section 263A. Conference Report at II–305. For this purpose, emergency gas is defined as natural gas stored in an underground storage facility or reservoir which is not cushion gas, but which nevertheless may be stored by the taxpayer in order to be available for periods of unusually heavy customer demand. After careful consideration of the matter, the temporary regulations, in keeping with the principles of uniformity and neutrality underlying the Act, do not provide a special exception for emergency gas. Accordingly, the capitalization rules of section 263A regarding property acquired for resale are applicable to emergency gas, which is regarded as part of the taxpayer's inventory under the Code.

Application of Section 263A to Foreign Persons

The provisions of section 263A (including the effective dates thereof) are applicable to all persons engaging in the production of property, or the acquisition of property for resale, including, for example, certain foreign persons which may be organized and operated exclusively outside the United States. Regulations contained in a separate document will be issued to provide further detailed guidance with respect to the application of the rules under section 263A for purposes of making certain determinations of the earnings and profits of all foreign corporations including, for example, determinations of the earnings and profits for purposes of sections 316, 902, 964, and 1248.

Transfers of Inventory Between Related Parties

Section 263A(h)(1) of the Code provides that the Secretary of the Treasury shall prescribe rules to carry out the purpose of section 263A, including regulations to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of this section. It has come to the attention of the Internal Revenue Service that certain taxpayers using the LIFO method of accounting may have contributed (or may contribute) inventory properties to subsidiaries (also using the LIFO method) in transactions described in section 351, shortly before the effective date of section 803 of the Act (i.e., taxable years beginning after December 31, 1986). Such transactions, although conducted for legitimate business purposes, could have the inadvertent effect of allowing the transferee to avoid (practically speaking) the necessity to restate beginning inventory balances under the change in method of accounting required under section 263A. Such avoidance could take place because, under certain authorities, the transferee would regard the transferred properties as newly acquired. Thus, under these authorities the transferee would not be required to restate those beginning inventory balances with reference to the transferor's production history, leading to an avoidance of the rules of section 263A which would have otherwise applied if such transfer had not taken place.

The regulations prevent this avoidance of section 263A by requiring that the inventory restatement be calculated by assuming that the inventory properties were still in the hands of the transferor on the restatement date. This provision of the regulations is effective for transfers of property occurring after September 18, 1986 (the date of filing with respect to the Conference Report of H.R. 3838).

Transitional Rules

With respect to taxpayers accounting for the costs of producing inventory, the change in accounting method resulting from the inclusion under section 263A of additional costs in inventory for the year of change will generally be treated as an automatic change in accounting method, initiated by the taxpayer and approved by the Commissioner. Thus, for example, no diminution in the amount of the section 481(a) adjustment shall occur by reason of amounts attributable to years preceding the effective date of the Internal Revenue Code of 1954.

The temporary regulations provide guidance to taxpayers regarding the changes in accounting methods required under section 263A and the amount and timing of the section 481(a) adjustment. Except as modified by the temporary regulations, the timing of the section 481(a) adjustment shall be determined under the administrative procedures applicable to a voluntary change in method of accounting in effect on January 1, 1987, i.e., Revenue Procedure 84-74, 1984-2 C.B. 736. The difference between the inventory as valued under prior law and the revalued inventory (*i.e.*, the increase in beginning inventory balances for the year of change) will represent the amount of adjustment to be taken into account under section 481 of the Code. The section 481(a) adjustment is allocated over a period not to exceed four years. In the case of property which is not inventory in the hands of the taxpayer, the temporary regulations apply to costs incurred after December 31, 1986, with no restatement of basis or capital account and no corresponding adjustment under section 481(a). Thus, for example, a real estate developer that holds homes for sale in the ordinary course of business would not restate the balance in its capital accounts or calculate a section 481(a) adjustment because such homes are not treated as merchandise includable in inventory. *See*, e.g., *W.C. and A.N. Miller Development v. Commissioner*, 81 T.C. 619 (1983).

The Internal Revenue Service intends to amend the general rules applicable to changes in methods of accounting to ensure that taxpayers failing to comply with the transitional provisions of section 263A will not receive more favorable treatment under the rules generally applicable to voluntary changes in methods of accounting.

Special Analyses

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required. A general notice of proposed rulemaking is not required for temporary regulations. Accordingly, the temporary regulations are not subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6). The collection of information requirements contained in this regulation have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. These requirements have been approved by OMB under control number 1545-.

Drafting Information

The principal author of these regulations is Paulette C. Galanko of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation with respect to matters of both substance and style.

List of Subjects

26 CFR 1.441-1—1.483-2

Income taxes, Accounting, Deferred compensation plans.

26 CFR 602

Reporting and recordkeeping requirements.

Amendments to the Regulations

For the reasons set out in the preamble, Subchapter A, Part 1 and Subchapter H, Part 602 of Title 26, Chapter 1 of the Code of Federal Regulations are amended as set forth below:

PART 1—[AMENDED]

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. * * * Section 1.263A-1T also issued under 26 U.S.C. 263A.

Par. 2. New § 1.263A-1T is added at the appropriate place to read as follows:

§ 1.263A-1T Capitalization and inclusion in inventory costs of certain expenses (temporary).

(a) *Introduction and effective date*—(1) *In general.* Except as otherwise provided, all costs that are incurred with respect to real or tangible personal property which is produced, or property which is acquired for resale, are to be capitalized with respect to such property. Rules are provided herein for the capitalization and allocation of costs among the various activities of the taxpayer. This section applies to costs incurred for the production of real property and tangible personal property. In the case of costs incurred with respect to property acquired for resale, this section applies to tangible and intangible property. Costs that are not treated as capitalized with respect to property produced or acquired for resale shall be accounted for under a proper method of accounting. See section 446 (c) and § 1.446-1.

(2) *Property produced in a farming business.* See paragraph (c) of this section for definitions and special rules applicable to costs incurred in a farming business.

(3) *Property acquired for resale.* See paragraph (d) of this section for rules relating to accounting for the costs of property acquired for resale.

(4) *Effective date.* In general, this section is effective for costs incurred after December 31, 1986, in taxable years ending after such date. In the case of property that is inventory in the hands of the taxpayer, this section is effective for taxable years beginning after December 31, 1986. See paragraph (e) of this section regarding the requirement that taxpayers change their method of accounting for inventory property.

(5) *Definitions and special rules*—(i) *Capitalize; allocate.* For purposes of this section, the term "capitalize" means, in the case of property that is inventory in the hands of the taxpayer, to include in inventory costs and, in the case of other property, to charge to capital accounts or basis. The term "allocate" means to apportion costs to various activities including production and resale activities with respect to which such costs will be capitalized. Capitalized costs are to be recovered through depreciation, amortization, cost of goods sold, as an adjustment to basis, or otherwise, at such time as the property is used, sold, or otherwise disposed of by the taxpayer. The recovery of such capitalized costs shall be in accordance with the rules in the applicable sections of the Code relating to such use, sale, or disposition.

(ii) *Produce.* For purposes of this section, the term "produce" includes construct, build, install, manufacture, develop, improve, create, raise or grow. Property produced for the taxpayer under a contract with the taxpayer is treated as property produced by the taxpayer to the extent that the taxpayer makes payments or otherwise incurs costs with respect to such property.

(iii) *Tangible personal property.* (A) *General rule.* For purposes of this section, the term "tangible personal property" includes films, sound recordings, video tapes, books and other similar property containing words, ideas, concepts, images or sounds. A sound recording is a work that results from the fixation of a series of musical, spoken, or other sounds, regardless of the nature of the material objects, such as discs, tapes or other phonorecordings, in which such sounds are embodied. The requirements of this section apply to the production of tangible personal property within the meaning of this paragraph (a)(5)(iii) without regard to whether such property is treated as tangible or intangible under other sections of the Code. Thus, the requirements of this section apply to the costs of the properties enumerated in this paragraph (a)(5)(iii) although such costs may consist of copyrights, licenses, manuscripts, and other items which may be treated as intangible for other purposes of the Code. For example, the costs of producing a book (including teaching aids and other similar property) required to be capitalized under this section include prepublication expenditures incurred by publishers of books and other similar property, including payments made to authors of literary works, as well as costs incurred by such publishers in the writing, editing, compiling, illustrating, designing and development of books or similar property. Such costs are required to be capitalized under this section without regard to whether such costs are determined to relate to the production of a manuscript or copyright of a book, as opposed to the physical costs (e.g., paper and ink) of printing and binding a book. See § 1.174-2 (a)(1) which provides that the term "research or experimental expenditures" does not include expenditures incurred for research in connection with literary, historical, or similar projects.

(B) *Clarification of effective date.* The provisions of this section as applied to the production of tangible personal property as defined herein (including prepublication expenditures of publishers), shall apply to such production activities under the effective date provisions of paragraph (a)(4) of this section.

(iv) *Trade or business.* For purposes of this section, activities of the taxpayer shall not constitute a separate trade or business solely by reason of classification as an inventory pool or a business unit (such as a "natural business unit" as defined in § 1.472-8(b)).

(6) *Exceptions for certain costs.* This section does not apply to:

(i) Any property produced by the taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit.

(ii) Any intangible drilling and development costs of oil and gas or geothermal wells allowable as a deduction under section 263(c), or any development or exploration costs of mineral property allowable as a deduction under sections 616(a) or 617(a) of the Code.

(iii) Any costs incurred for the production of property by the taxpayer pursuant to a long-term contract as defined in section 460, regardless of whether the taxpayer uses an inventory method to account for such production. (However, this section shall apply to property produced for the taxpayer under contract with the taxpayer to the extent that the taxpayer makes payments or otherwise incurs costs with respect to such property.)

(iv) Any amount allowable as a deduction under section 174.

(v) Any costs incurred for the production of property for use by the taxpayer in its trade or business if substantial construction of the property had occurred before March 1, 1986. For purposes of this section, substantial construction is deemed to have occurred if the lesser of—

(A) 10 percent of the total estimated costs of construction, or

(B) The greater of—

(*1*) $10 million or

(*2*) 2 percent of the total estimated costs of construction,

was incurred before March 1, 1986. For purposes of this provision, the total estimated costs of construction shall be determined by reference to a reasonable estimate, on or before March 1, 1986, of such amount. Assume, for example, that on March 1, 1986, the estimated costs of constructing a facility were $150 million. Assume that before March 1, 1986, $12 million of construction costs had been incurred. Based on the above facts, substantial construction would be deemed to have occurred before March 1, 1986, because $12 million (the costs of construction incurred before such date) is greater than $10 million (the lesser of $15 million or (the greater of $10 million or $3 million)). For purposes of this provision, construction costs are defined as those costs incurred after construction has commenced at the site of the property being constructed (unless the property will not be located on land and, therefore, the initial construction of the property must begin at a location other than the intended site). For example, in the case of a building, construction commences when work begins on the building, such as the excavation of the site, the pouring of pads for the building, or the driving of foundation pilings into the ground. Preliminary activities such as project engineering and architectural design do not constitute the commencement of construction, nor are such costs considered construction costs, for purposes of this paragraph (a)(6)(v).

(vi) Any costs incurred by a taxpayer with respect to natural gas acquired for resale to the extent that such costs would otherwise be allocable to "cushion gas". "Cushion gas" is the portion of gas stored in an underground storage facility or reservoir that is required to maintain the level or pressure necessary for operation of the facility. Costs incurred in connection with cushion gas are to be accounted for under the rules in effect before the enactment of section 263A to the Code.

(vii) Any costs incurred with respect to personal property acquired for resale by a taxpayer with average annual gross receipts that do not exceed $10 million. See paragraph (d)(2) of this section for rules and definitions.

(viii) Any costs incurred in raising, growing, or harvesting trees (including the costs associated with the real property underlying such trees), other than trees bearing fruit, nuts, or other crops, or ornamental trees. For purposes of this section, ornamental trees do not include evergreen trees that are more than six years old when severed from the roots. See paragraph (c) of this section for the treatment of costs incurred in connection with trees not covered by this exception.

(b) *Capitalization of costs*—(1) *In general.* Except as otherwise provided, the following rules shall apply in determining what costs are properly capitalized with respect to property which is produced or acquired for resale. (Hereinafter, the activities attributable to such property may be referred to as "production or resale activities".)

(2) *Types of costs*—(i) *Direct costs.* Direct material costs and direct labor costs must be capitalized with respect to a production or resale activity. "Direct

material costs" include the cost of those materials which become an integral part of the subject matter and the cost of those materials which are consumed in the ordinary course of the activity. "Direct labor costs" include the cost of labor which can be identified or associated with a particular activity. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes and payment to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor.

(ii) *Indirect costs—general description.* The term "indirect costs" includes all costs other than direct material costs and direct labor costs. All costs that directly benefit or are incurred by reason of the performance of a production or resale activity must be capitalized with respect to the property produced or acquired unless otherwise provided in paragraph (b)(2)(v) of this section. Certain types of costs may directly benefit, or be incurred by reason of the performance of a particular activity of the taxpayer even though the same types of costs also benefit other activities of the taxpayer. Accordingly, such costs require a reasonable allocation to determine the portion of such costs that are attributable to each activity of the taxpayer.

(iii) *Examples of indirect costs.* Indirect costs that must be capitalized with respect to production or resale activities include amounts incurred for:

(A) Repair of equipment or facilities;

(B) Maintenance of equipment or facilities;

(C) Utilities, such as heat, light, and power, relating to equipment or facilities;

(D) Rent of equipment, facilities, or land;

(E) Indirect labor and contract supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes and contributions to supplemental unemployment benefit plans;

(F) Indirect materials and supplies;

(G) Tools and equipment the costs of which are not otherwise capitalized:

(H) Quality control and inspection;

(I) Taxes otherwise allowable as a deduction under section 164 (other than State, local, and foreign income taxes) that relate to labor, materials, supplies, equipment, land or facilities, other than taxes described in section 164 that are paid or accrued by a taxpayer in connection with the acquisition of property described in paragraph (b)(2)(iii)(J) of this section and which are treated as part of the cost of such acquired property);

(J) Depreciation, amortization and cost recovery allowance on equipment and facilities (to the extent allowable as deductions under Chapter 1 of the Code);

(K) Depletion (whether or not in excess of cost);

(L) Administrative costs, whether or not performed on a job-site, but not including any cost of selling, or any return on capital;

(M) Direct and indirect costs incurred by any administrative, service, or support function or department to the extent such costs are allocable to particular activities pursuant to paragraph (b)(4) of this section;

(N) Compensation paid to officers attributable to services performed in connection with particular activities (but not including any cost of selling);

(O) Insurance, such as insurance on plant, machinery or equipment, or insurance on the subject matter of the activity;

(P) Contributions paid to or under a stock bonus, pension, profit-sharing or annuity plan, or other plan deferring the receipt of compensation whether or not the plan qualifies under section 401(a) (except for amounts described in paragraph (b)(2)(v)(H) of this section), and other employee benefit expenses paid or accrued on behalf of labor, to the extent such contributions or expenses are otherwise allowable as deductions under chapter 1 of the Code. "Other employee benefit expenses" include (but are not limited to): worker's compensation; amounts deductible or for whose payment reduction in earnings and profits is allowed under section 404A and the regulations thereunder; payments pursuant to a wage contribution plan under section 105(d) as it existed prior to its repeal in 1983; amounts includible in the gross income of employees under a method or arrangement of employer contributions or compensation which has the effect of a stock bonus, pension, profit-sharing or annuity plan, or other plan deferring receipt of compensation or providing deferred benefits; premiums on life and health insurance; and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, membership dues, etc.;

(Q) Rework labor, scrap and spoilage;

(R) Bidding expenses incurred in the solicitation of contracts, (including contracts pertaining to property acquired for resale) ultimately awarded to the taxpayer. For purposes of this section the term "bidding expenses" does not include any research and experimental expenses described in section 174 and the regulations thereunder. The taxpayer shall defer all bidding expenses paid or incurred in the solicitation of a particular contract until the contract is awarded. If the contract is awarded to the taxpayer, the bidding costs become part of the indirect costs allocated to the costs of the subject matter of the contract. If the contract is not awarded to the taxpayer, bidding costs become deductible in the taxable year the contract is awarded, or in the taxable year the taxpayer is notified in writing that no contract will be awarded and that the contract (or a similar or related contract) will not be re-bid, or in the taxable year that the taxpayer abandons its bid or proposal, whichever occurs first. Abandoning a bid does not include modifying, supplementing, or changing the original bid or proposal. If the taxpayer is awarded only part of the bid (for example, the taxpayer submitted one bid to build each of two different types of products and the taxpayer was awarded a contract to build only one of the two products), the taxpayer shall deduct the portion of the bidding expense related to the portion of the bid not awarded to the taxpayer. In the case of a bid or proposal for a multi-unit contract, however, all the bidding expenses shall be included in the costs allocated to the subject matter of the contract awarded to the taxpayer to produce or acquire for resale any of such units (for example, where the taxpayer submitted one bid to produce three similar turbines and the taxpayer was awarded a contract to produce only two of the three turbines);

(S) Engineering and design expenses (to the extent that such amounts are not research and experimental expenses as described in section 174 and the regulations thereunder); and

(T) To the extent not previously described as a direct or indirect cost subject to capitalization, the following items incurred with respect to production or resale activities:

(*1*) Storage and warehousing costs;

(*2*) Purchasing costs;

(*3*) Handling, processing, assembly, and repackaging costs; and

(*4*) A portion of general and administrative costs allocable to these functions.

(See paragraph (d)(3)(ii) of this section for definitions of these various types of costs with respect to property acquired for resale. Principles which are similar to the provisions of paragraph (d)(3)(ii) of this section shall apply in defining these various types of costs with respect to production activities).

(iv) *Allocation of interest expense to production activities*—(A) *In General.* Interest on debt incurred or continued to finance the production of real or tangible personal property to which this section otherwise applies must be capitalized, as provided in this paragraph. (Interest on debt incurred or continued to finance the acquisition and holding of property for resale is not required to be capitalized under this section). Interest paid or incurred during the production period must be capitalized if the property produced is:

(*1*) Real property;

(*2*) Personal property determined under section 168 to have a class life of 20 years or more;

(*3*) Personal property with an estimated production period in excess of 2 years; or

(*4*) Personal property with an estimated production period in excess of 1 year if the estimated cost of production exceeds $1 million.

For purposes of this paragraph, the production period begins on the date production of the property begins and ends on the date the property is ready to be placed in service or ready to be held for sale.

(B) *Avoided cost method.* The determination of the amount of debt that is treated as incurred or continued to finance production is based on the amount of interest expense that would have been avoided if production expenditures had not been made and the amount of such expenditures were used to repay the indebtedness of the taxpayer. Debt that can be specifically traced to a production activity must first be allocated to that activity. To the extent that production expenditures exceed the amount of debt specifically traceable to that production activity, other debt of the taxpayer is to be treated as allocable to the production activity. The interest rate to be applied to such additional allocable debt is the weighted average of the interest rates on the taxpayer's debt outstanding during the production period, other than debt specifically traced to a production activity. For purposes of this paragraph (b)(2)(iv)(b), production expenditures are those costs, including interest expense capitalized during the production period, required to be capitalized with respect to production under the rules of this section, without regard to whether such costs are incurred during the production period of the property to which the costs relate. (*E.g.*, production expenditures include planning and design activities which are generally incurred before the production period commences, as well as the costs of raw land and materials acquired before the production period commences).

(C) *Advance payments.* If production is undertaken for a customer who agrees to make progress payments or advance payments (or any other payments serving a similar purpose), for property to be held for sale to customers, or used in a trade or business or activity conducted for profit, the customer is treated as producing the property to the extent such progress payments or advance payments are made. (See paragraph (a)(5)(ii) of this section.) Moreover, the customer is treated as producing the property to the extent that the taxpayer incurs other costs (e.g., general and administrative costs) with respect to the property under production. Thus, interest on indebtedness incurred or continued during the production period to finance the payments made (and costs incurred) by the customer must be capitalized by the customer if such property is described in paragraph (b)(2)(iv)(A) of this section. In addition, the taxpayer producing the property for the customer must capitalized interest costs with respect to the property produced under the provisions of this paragraph to the extent that the production expenditures incurred by the taxpayer exceed the accumulated payments received from the customer with respect to such property.

(D) *Property used in production process.* Interest on debt incurred or continued to finance any asset (e.g., manufacturing equipment and facilities) that is used in the production or property described in paragraph (b)(2)(iv)(A) of this section shall be capitalized to the extent that such interest is paid or incurred during the production period of the property. The determination of the amount of debt that is treated as incurred or continued to finance any asset, and the interest attributable to such debt, shall be determined under the provisions of paragraph (b)(2)(iv)(B) of this section. Where an asset is used in the production of property and for other purposes, only the portion of such interest properly allocable to the production activity shall be capitalized.

(v) *Costs not capitalized.* Costs which are not required to be capitalized with respect to production or resale activities include amounts incurred for:

(A) Marketing, selling, advertising and distribution expenses;

(B) Bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer;

(C) General and administrative expenses (but not including any cost described in paragraph (b)(2)(iii) (L) or (M) of this section), and compensation paid to officers attributable to the performance of services that do not directly benefit or are not incurred by reason of a particular production activity;

(D) Research and experimental expenses (described in section 174 and the regulations thereunder);

(E) Losses under section 165 and the regulations thereunder;

(F) Depreciation, amortization and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle (for this purpose, an asset is not considered to be temporarily idle on non-working days, and an asset used in construction is considered to be idle when it is not enroute to or located at a job-site);

(G) Income taxes;

(H) (*1*) Contributions paid to or under a pension or annuity plan allowable as a deduction under section 404 (and section 404A if applicable) to the extent such contributions represent past service costs as determined under the particular funding method established for the plan for the period in question under the provisions of section 412;

(*2*) [Reserved.]

(I) Cost attributable to strikes; and

(J) Repair expenses that do not relate to the manufacture, or production of property.

(vi) *Costs provided by a related person.* (A) Any taxpayer engaging in production or resale activities shall capitalize any direct or indirect costs properly allocable to such activities although the materials, labor, or services (the "items") constituting the costs in question are provided to the taxpayer by a related person for a price which is less than the arm's length charge for such items. In such a situation, both the taxpayer and the related person shall account for the transaction for federal income tax purposes as if the taxpayer purchased the items in question for their arm's length charge from the related person. Thus, for example, the taxpayer shall capitalize an amount equal to the arm's length charge for such items and the related person shall include in income an amount equal to such arm's length charge.

(B) The provisions of this paragraph (b)(2)(vi) shall not apply if, and to the extent, the transaction is properly accounted for in such a manner as to result in the capitalization (or deferral of the deduction) of the costs of the items by the related party, and the related party does not deduct such costs earlier than the time that the costs would have been deducted by the taxpayer had the costs been initially capitalized by the taxpayer. Thus, for example, the provisions of this paragraph (b)(2)(vi) shall not apply if, and to the extent, that the transaction is treated as a deferred intercompany transaction under § 1.1502-13, and the gain or loss is deferred by the selling member under that section. In addition, the provisions of this paragraph (b)(2)(vi) shall not apply if, and to the extent, it would not be appropriate under the principles of section 482 for the Commissioner to adjust the income of the taxpayer or the related person with respect to the transaction at issue.

(C) For purposes of this paragraph (b)(2)(vi), an "arm's length charge" for an item shall mean the arm's length charge (or other appropriate charge, where applicable) established under the principles of section 482. Thus, for example, the term "arm's length charge" may refer to the cost of an item, if such treatment is allowed under the principles of section 482. In addition, the principles of section 482 shall apply in determining the various correlative adjustments which shall occur by reason of the required accounting treatment of these transactions. For purposes of this paragraph (b)(2)(vi), a taxpayer shall be related to another person if the taxpayer and such person are described in section 482 of the Code.

(vii) *Practical capacity*. [Reserved.]

(viii) *Examples*.

Example (1). The taxpayer A, owns and operates a manufacturing facility which produces tangible personal property, the costs of which are subject to the capitalization rules of this section. Normally, two separate shifts of production workers are employed at the facility during a typical work day. However, for various business reasons, during a particular period of time, none of the production workers report for work at the facility, and the facility is not used during any of the normally scheduled work days in such period. Under this section, the facility is considered to be temporarily idle for purposes of paragraph (b)(2)(v)(F) of this section, and thus A is allowed to expense depreciation, amortization, and cost recovery allowances on the facility and the equipment contained therein with respect to the normally scheduled work days for which the facility and equipment are completely idle.

Example (2). Assume the same facts as in example (1), except that, for various business reasons during a particular period of time, only one shift of production workers report for work at the facility, and the facility is not used for the duration of the remaining work day. Under this section, the facility is not considered to be temporarily idle for purposes of paragraph (b)(2)(v)(F) of this section.

Example (3). The taxpayer B, owns and operates a manufacturing facility which produces tangible personal property, the costs of which are subject to the capitalization rules of this section. The facility normally runs 24 hours a day, and typically produces 1000 units of product for each day's operations. However, for various business reasons, during a particular period of time, the facility continues to operate 24 hours a day, but only produces 700 units of product for each day's operations. The same result occurs as in example (2), *i.e.*, the facility is not considered to be temporarily idle for purposes of paragraph (b)(2)(v)(F) of this section.

(3) *Allocation methods*—(i) *Direct labor*. Direct labor costs incurred during the taxable year shall generally be allocated to or among activities using a specific identification (or "tracing") method. However, direct labor costs may be allocated to or among particular activities using any method, provided that the method employed reasonably allocates direct labor costs among such activities. For the purpose of allocating elements of direct labor cost (other than basic compensation) to particular activities, all such cost elements may be grouped together and then allocated to or among activities in proportion to the charge for basic compensation. Under this paragraph, a taxpayer must capitalize all of its direct costs. Nevertheless, a taxpayer will not be treated as using an incorrect method of accounting if the taxpayer treats any direct costs as indirect costs, provided such costs are capitalized to the extent provided by paragraph (b)(3)(iii) of this section. Thus, for example, a taxpayer may treat direct labor costs as part of indirect costs (for example, by use of the conversion cost method), provided all such costs are capitalized as provided by paragraph (b)(3)(iii) of this section.

(ii) *Direct materials*. The cost of direct materials shall generally be allocated to the activity for that year, using the taxpayer's method of accounting for the inventories containing such materials (e.g., specific identification, FIFO, LIFO). Direct materials which are not accounted for under the provisions of the preceding sentence shall be allocated to an activity using a tracing method or any other method which reasonably allocates such direct material costs among activities.

(iii) *Indirect costs*—(A) *In general*. (*1*) The indirect costs required to be allocated to or among production or resale activities under paragraph (b)(2) of this section shall be allocated to particular activities using either a specific identification (or "tracing") method, the standard cost method, or a method using burden rates (such as ratios based on direct costs, hours, or other items, or similar formulas), so long as the method employed for such allocation reasonably allocates indirect costs among production or resale activities. Indirect costs may ordinarily be allocated to production and resale activities on the basis of direct labor and material costs, direct labor hours, or any other basis which results in a reasonable allocation of such indirect costs.

(*2*) An allocation method under this paragraph (b)(3) will not be considered to be reasonable if such method does not result in the capitalization of all costs that directly benefit or are incurred by reason of the performance of production or resale activity as described in paragraph (b)(2)(ii) of this section. However, an allocation method that fails to meet these requirements may be used by the taxpayer if, with respect to the taxpayer's production or resale activities taken as a whole—

(*i*) The total amounts of such costs which the taxpayer capitalizes during the taxable year do not differ significantly (with appropriate consideration being given to the volume of the taxpayer's production or resale activities) from the total amounts which would be capitalized under the requirements of the preceding sentence; and

(*ii*) The allocation method is applied consistently by the taxpayer, and does not result in a significantly disproportionate allocation of costs to production or resale activities in such a manner as to circumvent the principles of this section.

The principles of this paragraph (b)(3)(iii)(A)(*2*) shall also be applicable with respect to the use of the simplified production method (as described in paragraph (b)(5) of this section), the simplified service cost method (as described in paragraph (b)(6) of this section), and the simplified resale method (as described in paragraph (d)(3) of this section). Thus, the use of various allocation procedures under those methods shall be permitted although such procedures may otherwise fail to meet the respective requirements of those methods, if the procedures satisfy the requirements of this paragraph (b)(3)(iii)(A)(*2*).

(*3*) In the event that the allocation methods (such as burden rates, or the standard cost method) utilized by a taxpayer under its method of accounting prior to the effective date of the Tax Reform Act of 1986 do not result in the allocation of sufficient amounts of indirect costs to production or resale activities under this section:

(*1*) The taxpayer shall change its burden rates, standard costs, or other methods, to increase the amount of indirect costs being allocated to production or resale activities; or

(*ii*) The taxpayer may retain the use of its present burden rates, standard costs, or other methods, but shall adopt further methods (including, but not limited to, additional burden rates or standard costs), to ensure that adequate amounts of indirect costs are allocated to production or resale activities.

(B) [Reserved.]

(C) *Burden rates.* (*1*) *In general.* Burden rates may be developed in accordance with acceptable accounting principles and applied in a reasonable manner. If a taxpayer chooses, it may allocate different indirect costs on the basis of different burden rates. Thus, for example, the taxpayer may use one burden rate for allocating rent and another burden rate for allocating utilities. Any change in a burden rate which is merely a periodic adjustment to reflect current operating conditions, such as increases in automation or changes in operation, does not constitute a change in method of accounting under section 446. However, a change in the concept under which such rates are developed does constitute a change in method requiring the consent of the Commissioner, except as provided in paragraph (e) of this section. The taxpayer shall maintain adequate records and working papers to support all burden rate calculations.

(*2*) *Development of burden rates.* The following factors, among others, may be taken into account in developing burden rates:

(*i*) The selection of an appropriate level of activity and period of time upon which to base the calculation of rates which will reflect operating conditions for purposes of unit costs being determined;

(*ii*) The selection of an appropriate statistical base such as direct labor hours, direct labor dollars, or machine hours, or a combination thereof, upon which to apply the overhead rate to determine costs; and

(*iii*) The appropriate budgeting, classification and analysis of expenses (for example, the analysis of fixed and variable costs).

(*3*) *Operation of the burden rate method.* The purpose of the burden rate method is to allocate an appropriate amount of indirect costs to production or resale activities through the use of predetermined rates intended to approximate the actual amount of indirect costs incurred. Accordingly, the proper use of the burden rate method under this section requires that any net negative or net positive difference between the total predetermined amount of costs allocated to property and the total amount of indirect costs actually incurred and required to be allocated to such property (i.e., the under or over-applied burden) must be treated as an adjustment to the taxpayer's ending inventory or capital account (as the case may be) in the taxable year in which such difference arises. However, if such adjustment is not significant in amount in relation to the taxpayer's total indirect costs incurred with respect to production or resale activities for the year, then such adjustment need not be allocated to the property produced or acquired for resale unless such allocation is made in the taxpayer's financial reports. The taxpayer must treat both positive and negative adjustments consistently.

(D) *Standard cost method.* (*1*) *In general.* A taxpayer may use the "standard cost" method of allocating costs, provided that variances are treated in accordance with the procedures prescribed. For purposes of this section, a "net positive overhead variance" shall mean the excess of total standard indirect costs over total actual indirect costs and a "net negative overhead variance" shall mean the excess of total actual indirect costs over total standard indirect costs.

(*2*) *Treatment of variances.* The proper use of the standard cost method requires that a taxpayer must reallocate to property a pro rata portion of any net negative or net positive overhead variances and any net negative or net positive direct cost variances. The taxpayer must apportion such variances to or among the property to which the costs are allocable. However, if such variances are not significant in amount in relation to the taxpayer's total indirect costs incurred with respect to production and resale activities for the year, then such variances need not be allocated to property produced or acquired for resale unless such allocation is made in the taxpayer's financial reports. The taxpayer must treat both positive and negative variances consistently.

(4) *Allocation of administrative, service, or support costs to activities*—(i) *Introduction.* If a function or department of the taxpayer incurs costs that directly benefit particular production or resale activities of the taxpayer, the costs of such function or department are allocable to such activities. See paragraph (b)(3) of this section. However, if a function or department incurs costs that do not directly benefit particular production or resale activities but rather, for example, benefit only the overall management or policy guidance functions of the taxpayer, the costs incurred by such function or department are not allocable to production or resale activities. In some cases, the costs incurred by a function or department may directly benefit particular production or resale activities as well as the taxpayer's other functions, such as overall management or policy guidance functions. In such cases, the taxpayer shall reasonably allocate the costs of such function or department between the taxpayer's production or resale activities and the taxpayer's other functions. Paragragh (b)(3)(iii) and (4)(iii) of this section provide guidance as to what constitutes a reasonable method of allocating these costs.

(ii) *General rule.* The total direct and indirect costs ("service costs") of administrative, service, or support functions or departments ("service departments") that directly benefit a particular production or resale activity shall be directly allocated to such activity; if service costs directly benefit more than one production or resale activity, then such costs shall be allocated to particular activities under the principles of this paragraph. The service costs that benefit production or resale activities as well as other functions ("mixed service costs") shall be allocated to particular activities or functions on the basis of a factor or relationship that reasonably relates the incurring of the service cost to the benefits received by the activity. In general, the direct costs of a service department include costs that can be identified specifically with the services provided by the department, and the indirect costs of a service department include costs not identified specifically with the services provided by the function or department, but incurred by reason of the direct costs of the function or department. Such direct and indirect costs include, but are not limited to, compensation (including compensation referred to in paragraph (b)(2)(i) of this section) of employees directly engaged in performing the services provided by the department, travel, materials and supplies consumed by the department, supervisory and clerical compensation, occupancy costs (rents or an allocable share of depreciation and property taxes), depreciation or rent of office machines, utilities, telephone, and other department overhead. The types of activities that are administrative, service or support functions or departments are not predetermined, but depend upon the facts and circumstances of each taxpayer's activities and business organization. In a decentralized business organization, all costs incurred at higher levels, for example, at a parent corporation or organization or at the headquarters of a subsidiary corporation or division, are not necessarily general and administrative expenses (as described in paragraph (b)(2)(v)(C) of this section) with respect to particular activities.

(iii) *Rules for allocation of service costs.* The taxpayer shall allocate the total direct and indirect costs of a service department to activities by applying consistently any reasonable method of cost allocation as described in paragraph (b)(3)(iii) of this section. (However, for purposes of this section, a method shall not be considered to be reasonable if such method effectively allocates service department costs to other service departments in such a manner as to avoid the eventual reallocation of such costs to production and resale activities if such reallocation would be otherwise required under the principles of this section). The following methods are provided as examples of reasonable methods for allocating service department costs under this section. Any other reasonable method, as described in paragraph (b)(3)(iii) of this section, may also be used to allocate such service department costs under this section.

(A) *Direct reallocation method.* The direct reallocation method, whereby the total costs (direct and indirect) of all service departments are allocated only to departments or cost centers engaged in production or resale activities and then from those departments to particular activities. This direct reallocation method ignores benefits provided by one service department for other service departments, and also excludes such other service departments from the base used to make the allocation; or

(B) *Step-allocation.* The step-allocation method, whereby a sequence of allocations is made beginning with the allocation to other service departments and to departments engaged in the performance of production or resale activities, of the total costs (direct and indirect) of the service departments, and ending with the allocation of the total costs (including the costs allocated to it from the other service departments) of the service department that provides benefits to the least number of other service departments. Under this allocation method, the cost of service departments allocated properly to functions or departments that are not service departments or departments performing the production or resale activities (for example, payroll costs allocated to a financial planning function or department) are not reallocated to any other service department or department performing the activities. The taxpayer shall then allocate the costs of the departments performing the activities (including the reallocated service department costs) to particular production or resale activities.

(iv) *Relationship of service costs to benefits received.* Factors or relationships that relate the incurring of service costs to the benefits received by particular production or resale activities include measures based upon the total output of the service department (for example, the approximate amount of service hours or the approximate number or the dollar value of transactions provided to an activity as a fraction of the total amount of service hours or the total amount or the total dollar volume of transactions provided by the department), or measures based upon the relative size of the production or resale activity to the size of the taxpayer's other activities (for example, the number of direct labor employees or direct labor hours or direct labor costs (as referred to in paragraph (b)(2)(i) of this section) incurred in connection with a particular activity as a fraction of the total amount of direct labor costs incurred by the taxpayer in all activities).

(v) *Additional requirements.* (A) The amount of administrative, service, or support costs required to be allocated under this section include the costs of purchasing such services from a third person. In the case of services performed by a related party, see paragraph (b)(2)(vi) of this section for the accounting treatment required of such transactions. In addition, if pursuant to section 482 and the regulations thereunder the district director makes an allocation of income or deductions between members of a group of controlled entities to reflect the performance of services or the provision of materials, equipment or facilities at other than an arm's length charge, any taxpayer that is affected by such allocation is required to take such allocation into account in making the taxpayer's allocation to production and resale activities of the costs of administrative service or support functions or departments.

(B) If the taxpayer establishes to the satisfaction of the district director that all of a particular type of administrative, service or support function is performed only at a particular jobsite or location (that is, at the offices of a production plant, warehouse, storage facility, or at a construction site), then all the direct and indirect costs of such function incurred at the jobsite or location shall be directly allocated to each particular activity performed at that jobsite or location, and no further allocation of that type of cost shall be required.

(C) Regardless of the particular allocation method being used by the taxpayer to allocate service costs, the taxpayer shall maintain the records used to make service cost allocations so that the allocations may be readily examined and verified by the district director. The taxpayer shall also maintain records describing the types of costs that the taxpayer has deducted currently under paragraph (b)(2)(v)(C) of this section (general and administrative expenses), so that the amount, nature, and allocation of such costs may be verified readily by the district director. A change in the method or base used in allocating such service costs (such as changing from an allocation base using direct labor cost to a base using direct labor hours), or a change in the taxpayer's determination of what functions or departments of the taxpayer are required or not required to be allocated is a change in method of accounting to which section 446(e) and the regulations and procedures thereunder apply. See § 1.446-1 (e) and paragraph (e)(11) of this section.

(vi) *Illustration of types of activities with respect to which costs ordinarily are required to be allocated.* Costs incurred by the following types of functions or departments ordinarily are required to be allocated among production or resale activities:

(A) The administration and coordination of production and resale activities (wherever performed in the business organization of the taxpayer);

(B) Personnel operations, including the cost of recruiting, hiring, relocating, assigning, and maintaining personnel records or employees;

(C) Purchasing operations, including purchasing materials and equipment, scheduling and coordinating delivery and return of materials and equipment to or from factories or jobsites, and expediting and follow-up;

(D) Materials handling and warehousing and storage operations;

(E) Accounting and data services operations, including cost accounting, accounts payable, disbursements, billing, accounts receivable and payroll;

(F) Data processing;

(G) Security services; and

(H) Legal departments.

(vii) *Illustration of types of activities with respect to which costs ordinarily are not required to be allocated.* Costs incurred by the following types of functions or departments ordinarily are not required to be allocated to particular activities:

(A) Functions or departments responsible for overall management of the taxpayer, or for setting overall policy for all of the taxpayer's activities or trades or businesses (such as the board of directors (including their immediate staff), and the chief executive, financial, accounting and legal officers (including their immediate staffs) of the taxpayer, provided that no substantial part of the cost of such departments or functions directly benefit a particular production or resale activity;

(B) General business planning;

(C) Financial accounting (including the accounting services required to prepare consolidated reports, but not including any accounting for particular production or resale activities);

(D) General financial planning (including general budgeting) and financial management (including bank relations and cash management);

(E) General economic analysis and forecasting;

(F) Internal audit;

(G) Shareholder, public and industrial relations;

(H) Tax department;

(I) Other departments or functions that are not responsible for day-to-day operations but are instead responsible for setting policy and establishing procedures to be used with respect to all of the taxpayer's activities or trades or businesses, as described in paragraph (b)(4)(viii) of this section; and

(J) Marketing, selling, or advertising.

(viii) *Policy and overall management services.* Examples of such departments or functions that are responsible for setting policy and establishing procedures applicable to all of the taxpayer's activities or trades or businesses (see paragraph (b)(4)(vii)(I) of this section) are:

(A) Personnel policy (such as establishing and managing personnel policy in general, developing general wage, salary and benefit policies, developing employee training programs unrelated to particular activities, negotiations with labor unions and relations with retired workers);

(B) Quality control policy;

(C) Safety engineering policy;

(D) Insurance or risk management policy (but not including bid or performance bonds or insurance related to particular activities); and

(E) Environmental management policy. However, the cost of establishing any system or procedure that will only benefit a particular production or resale activity shall be directly allocated to such activity.

(F) [Reserved.]

(ix) *Costs not described.* The costs of any administrative, service or support function or department of the taxpayer not described in paragraph (b)(4) of this section are required to be allocated to particular production or resale activities to the extent that the nature of the benefits provided by such function or department more closely resembles the type of benefits described in paragraph (b)(4)(vi) of this section than the type of benefits described in paragraph (b)(4)(vii) of this section.

(x) *Illustrations of the allocations required by this paragraph (b)(4).* The following illustrate the types of considerations that are to be taken into account in making the allocations required by paragraph (b)(4)(iii) of this section. The Taxpayer need not use the same method to allocate a particular type of administrative, service or support cost as the method described in these illustrations provided that the method used by the taxpayer is reasonable. See paragraph (b)(4) of this section. In addition, the particular allocation methods illustrated herein may be used to allocate other types of services costs not illustrated in this paragraph.

(A) *Security services.* The cost of security or protection services benefit all areas covered by the services and should be allocated to each physical area that receives the service in proportion either to the size of the physical area, number of employees in the area, or the relative fair market value of assets located in the area, or on any other reasonable basis applied consistently. That part of the total cost allocable to a factory, warehouse, or jobsite where only one activity is performed shall be directly allocated to that activity. The treatment of the cost of security services allocable to other service departments depends upon the method of allocation adopted by the taxpayer under paragraph (b)(4)(iii) of this section.

(B) *Legal services.* The cost of a legal department to include rent (or an allocation of building depreciation and occupancy costs), travel, office machines, supplies, telephone, library, and other overhead and the compensation of the attorneys and other employees assigned to the department. For this purpose compensation described in paragraph (b)(2) of this section. These costs only benefit activities of the taxpayer which require legal services. These costs are generally allocable directly to a particular activity on the basis of the approximate number or hours of legal service (including research) performed in connection with the activity, including bidding, negotiating, drafting, or reviewing a contract (including subcontracts and supply contracts), obtaining necessary licenses and permits, and in resolving disputes, termination claims or disputes arising from the performance of the activity. Different hourly rates may be appropriate for different services. In determining the number of hours allocable to any activity, approximations are appropriate, detailed time records need not be kept, and insubstantial amounts of services provided to an activity by senior legal staff as an administrator or a reviewer may be ignored The taxpayer shall also allocate directly to an activity the cost of any outside legal services provided. Instead of an allocation based upon total hours of legal services provided to an activity, the taxpayer may choose to allocate the costs of a legal department to particular activities on the basis of total direct costs (as described in paragraph (b)(2)(i) of this section) incurred with respect to each activity as a fraction of the total direct costs incurred with respect to all production or resale activities. Legal activities relating to general corporate functions, financing, securities law, compliance, antitrust law compliance, tax compliance, industrial relations, compliance with laws and regulations not related to particular activities, after-the-fact review of contracts to insure compliance with company policies, patents and licensing unrelated to particular activities, and similar general legal functions are not required to be allocated to particular activities.

(C) *Centralized payroll department.* The cost of a payroll department includes rent (or an allocation of building depreciation and occupancy costs), office machines, supplies, telephones and other overhead and compensation of employees assigned to the department. The department cost may also include the cost of data processing and file maintenance, or this cost may be incurred by a separate data processing or records department and allocated to the payroll department. Payroll service costs benefit any department, including other service departments, incurring labor costs. The cost of payroll department is generally allocated on the basis of the gross amount of payroll processed.

(D) *Centralized data processing.* The cost of a data processing department includes rent or depreciation of data processing machines, supplies, rent (or an allocation of building depreciation and occupancy costs), power, telephone and other overhead, and the compensation of employees assigned to the department. These costs benefit all departments that require data processing services. Data processing costs are generally allocated based upon the number of data processing hours supplied. Other reasonable bases, such as an allocation based upon total direct cost, may also be used. The costs of data processing systems developed for a particular activity shall be directly allocated to such activity.

(E) *Engineering and design services.* The cost of an engineering or design department includes rent (or an allocation of building depreciation and occupancy costs), travel, office machines, supplies, telephones, library, and other overhead, and compensation of employees assigned to the department. Unless the engineering and design services are properly accounted for separately, the cost of engineering or design service departments generally is directly allocable to an activity on the basis of the approximate number of hours or work performed with respect to a particular activity as a fraction of the total hours of engineering or design work performed for all activities. Different services may be allocated at different hourly rates. Engineering and design services may also be treated as direct costs of an activity, provided that the taxpayer also treats all engineering and design overhead as direct or indirect costs of the activity.

(F) *Safety engineering.* The cost of a safety engineering department includes the compensation paid to employees assigned to the department, rent (or an allocation of building depreciation and occupancy costs), travel, office machines, supplies, telephones, library, and other overhead. These costs benefits all activities of the taxpayer and should be allocated to particular activities on the basis of the approximate number of safety inspections made in connection with a particular activity as a fraction of total inspections, or on basis of the number of employees assigned to an activity as a fraction of total employees or on the basis of total labor hours worked in connection with an activity as a fraction of total hours, whichever is most reasonable. The cost of a safety engineering department responsible only for setting safety policy and establishing safety procedures to be used in all of the taxpayer's activities is not required to be allocated. However, in determining the total costs of safety engineering department to be allocated, costs attributable to providing a safety program only for a particular activity shall be directly assigned to such activity.

(5) *Simplified method of accounting for production costs*—(i) *In general.* Taxpayers may elect to use the "simplified production method" permitted under this paragraph (b)(5) to account for the additional costs required to be capitalized under this section with respect to property produced by the taxpayer that is:

(A) Stock in trade of the taxpayer or other property that is properly includable in the inventory of the taxpayer; or

(B) Property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

The simplified production method is not available with respect to property acquired for resale, property constructed by a taxpayer for use in its trade or business, property produced under a long-term contract, or any other property produced by a taxpayer that is not described in section 1221(1) of the Internal Revenue Code. In the case of a single trade or business that consists of operations including both production of property and the acquisition of property for resale, the simplified production method, if elected, must be applied with respect to all operations of the particular trade or business. In such a case, a taxpayer is not permitted to apply the simplified production method to only a portion of the operations of such trade or business. In addition, the taxpayer may not apply the simplified resale method to any portion of such trade or business.

(ii) *Allocation of additional section 263A costs.* Under the simplified production method, additional section 263A costs are to be allocated to inventory or other property based on the ratio of the taxpayer's total additional section 263A costs incurred during the taxable year to the taxpayer's total section 471 costs incurred during the taxpayer's total year (the "absorption ratio"). (See paragraph (b)(5)(iii) of this section for definitions of the certain terms used in this paragraph (b)(5)(ii)). The amount of additional section 263A costs required to be capitalized is computed by multiplying the absorption ratio times the amount of section 471 costs remaining in the taxpayer's ending "section 471 inventory balance" that are treated as costs incurred during the taxable year under the taxpayer's method of accounting (e.g., the last-in, first-out method or "LIFO"). Thus, in the case of a taxpayer using the LIFO method of accounting, the absorption ratio is applied to the increase (LIFO increment), if any, in the taxpayer's ending section 471 balance for the taxable year. In the case of a taxpayer using the first-in, first-out ("FIFO") method of accounting, the absorption ratio is applied to the amounts of section 471 costs remaining in the taxpayer's ending section 471 balance that are treated as having been incurred in the taxable year.

(iii) *Definitions.* Additional section 263A costs are those costs, other than interest, that were not capitalized or included in inventory costs under the taxpayer's method of accounting immediately prior to the effective date of this section, but that are required to be capitalized under this section. (See paragraph (b)(2)(iv) of this section for the rules relating to the allocation of interest expense.) Although such additional section 263A costs are allocated under the simplified production method permitted in this paragraph (b)(5), such costs shall otherwise be treated as inventory costs for all purposes of the Code except as provided herein. For purposes of this paragraph (b)(5), the costs capitalized or included in inventory costs under the taxpayer's method of accounting immediately prior to the effective date of this section shall be referred to as "section 471 costs". Thus, if a taxpayer included a particular cost described in § 1.471–11(c)(2)(iii) in inventory, such cost is also required to be included in the taxpayer's inventory as a section 471 cost for purposes of this paragraph (b)(5). For purposes of this paragraph (b)(5), the taxpayer's section 471 inventory balance is the balance of section 471 costs, determined without the inclusion of any additional section 263A costs. (Morever, the term "section 471 costs" shall include any cost includable in production costs under the taxpayer's prior method regardless of whether such prior method required the absorption of costs to inventories under § 1.471–11).

(iv) *LIFO indexes.* In the case of a taxpayer using the LIFO method of accounting for inventories, the calculation of a particular year's index is to be made without regard to the additional section 263A costs. Similary, the taxpayer shall disregard the additional section 263A costs in adjusting current year costs by the applicable indexes, in determining whether there has been an inventory increment or decrement for the current year in question for the particular LIFO pool. If the taxpayer determines that there has been an inventory increment, then the taxpayer shall state the amount of the increment in current year dollars, and then multiply the resulting amount by the absorption ratio, as previously described. The resulting product is equal to the amount of the additional section 263A costs which the taxpayer is required to capitalize in ending inventory. If the taxpayer determines that there has been an inventory decrement, then the taxpayer shall state the amount of the decrement in dollars applicable to the particular year for which the LIFO cost or layer has been invaded. The additional section 263A costs, incurred in prior years, which are applicable to the decrement shall be charged to cost of goods sold. The additional section 263A costs which are applicable to the decrement are determined by multiplying the total amount of such section 263A costs allocated to the layer of the particular pool in which the decrement occurred, by the ratio of the decrement to the total section 471 costs (excluding, therefore, additional section 263A costs) in the layer for such pool.

(v) *Examples.* The operation of the simplified production method is illustrated in the following examples:

Example (1). The taxpayer A, uses the first-in, first-out (FIFO) method of accounting for inventories. A includes in inventoriable costs under its section 471 method of accounting (i) direct production costs as described in § 1.471–11(b)(2) ("full absorption direct costs"), and (ii) indirect production costs described in § 1.471–11(c)(2)(i) ("category 1 costs"). All other costs incurred by A are excluded from section 471 costs under A's method of accounting, including costs described in § 1.471–11(c)(2) (ii) and (iii) ("category 2" and "category 3" costs respectively). A determines, pursuant to this section, that it incurred $1 million of additional section 263A costs during the taxable year. Furthermore, assume that A had a beginning section 471 inventory balance (consisting of its full absorption direct costs and category 1 costs) of $2 million, incurred $10 million of such section 471 costs during the year, and had an ending section 471 inventory balance of $3 million. The absorption ratio for the year is equal to 10 percent, i.e., additional section 263A costs of $1 million, divided by section 471 costs incurred during the taxable year of $10 million. All of A's costs in ending inventory are viewed as section 471 costs incurred during the taxable year. Thus, for each dollar in the ending section 471 inventory balance, A must capitalize 10 cents of additional section 263A costs. Ending inventory for the taxable year would be increased by $300,000. The balance of the taxpayer's additional section 263A costs would be viewed as included in cost of goods sold.

Example (2). The taxpayer B uses the last-in, first-out (LIFO) method of accounting for inventories. B includes in inventoriable costs under its section 471 method of accounting: (i) full absorption direct costs, (ii) category 1 costs, and (iii) certain category 3 costs. B determines, pursuant to this section, that it incurred $1 million of additional section 263A costs during the taxable year. Furthermore, assume that B had a beginning section 471 inventory balance (consisting of full absorption direct costs, category 1 costs, and certain category 3 costs) of $2 million, incurred $10 million of such section 471 costs during the year, and had an ending balance of section 471 costs of $3 million. The absorption ratio for the year is equal to 10 percent, *i.e.*, additional section 263A costs of $1,000,000, divided by section 471 costs incurred during the taxable year of $10 million. The increase in B's section 471 inventory balance for the taxable year is $1 million. Thus, B must capitalize $100,000 of additional section 263A costs in ending inventory (*i.e.*, .10 times $1,000,000). The balance of B's additional section 263A costs would be included in cost of goods sold for the taxable year. Assume that in the following taxable year, B is viewed as disposing of inventory acquired in the preceding year having section 471 costs of $500,000. B would be required to include, in cost of goods sold, a proportional amount of its additional section 263A costs for such preceding year, i.e., $50,000 (.10 times $500,000).

Example (3). The taxpayer R begins its trade or business in Year 1, and uses the LIFO method of accounting for inventories. R includes in inventoriable costs under its section 471 method of accounting: (i) full absorption direct costs, and (ii) category 1 costs. R determines, pursuant to this section, that it incurred $1,000 of additional section 263A costs during the taxable year. Furthermore, assume that R had no beginning section 471 inventory balance (due to entering the trade or business in Year 1), incurred $10,000 of such section 471 costs during the year, and had an ending balance of section 471 costs of $3,000, contained in three LIFO pools (A, B, and C). R allocates its additional section 263A costs for taxable Year 1 in the following manner:

Year 1

Additional section 263A costs, $1,000 divided by Section 471 costs, $10,000 equals 10% absorption ratio

	Total	A	B	C
Year 1				
Ending section 471 balance	$3,000	$1,600	$600	$800
Absorption ratio	.10	.10	.10	.10
Current additional section 263A costs	300	160	60	80
Final ending inventory balance	3,300	1,760	660	880

In Year 2, R incures $400 of additional section 263A costs and $2,000 of section 471 costs. Moreover, R has $1,000 of section 471 cost of goods sold in pools A, B, and C. R computes its final inventory for Year 2 as follows:

Year 2

Additional section 263A costs, $400 divided by Section 471 costs, $2,000 equals 20% absorption ratio

	Total	A	B	C
Year 2				
Beginning section 471 balance	$3,000	$1,600	$600	$800
Current section 471 costs	2,000	1,500	300	200
Section 471 cost of goods sold	(1,000)	(300)	(300)	(400)
Ending section 471 balance	4,000	2,800	600	600
Prior period additional section 263A costs	300	160	60	80
Included in cost of goods sold	(20)			(20)
Remaining prior period additional section 263A costs	280	160	60	60
Current additional section 263A costs	240	240		
Final ending inventory balance	4,520	3,200	660	660

Pool C is reduced by $200 in Year 2. A portion of the additional 263A costs contained in that pool that are attributable to Year 1 must be included in cost of goods sold in Year 2. The amount is determined by dividing the decrement in pool C by the total costs accumulated in the Year 1 layer of pool C; the resulting fraction is then multiplied by the additional section 263A costs contained in pool C which are attributable to Year 1. Thus, the amount of additional section 263A costs which is included in cost of goods sold from pool C, attributable to Year 1, is $20, i.e., $200 divided by $800, multiplied by $80.

(vi) *Change in method of accounting.* The election to use the simplified production method shall be made separately for each trade or business of the taxpayer on a timely filed income tax return for the taxpayer's first taxable year for which this section becomes effective. For taxable years subsequent to such taxable year of the taxpayer, a change in method to, or from, the simplified production method requires the consent of the Commissioner. In addition, any change in the determination of the taxpayer's section 471 costs which would constitute a change in method of accounting under the law in effect before the enactment of section 263A, shall be deemed to constitute a change in method of accounting under this section.

(6) *Simplified procedure for allocating mixed service costs*—(i) *In general.* This paragraph provides a simplified method (the "simplified service cost method") for allocating administrative, support and service costs that directly benefit or are incurred by reason of the performance of production activities but also benefit other activities of the taxpayer ("mixed service costs"). The simplified service cost method provided under this paragraph (b)(6) may be used to determine the aggregate portion of mixed service costs which are required to be capitalized as production costs ("inventoriable mixed service costs"). For purposes of this method, mixed service costs do not include administrative, support, and service costs that directly benefit or are incurred by reason of the performance of the production activities of the taxpayer ("production service costs"), if such costs do not benefit other activities in the taxpayer's trade or business, or if such costs are properly allocated to production activities under the taxpayer's method of accounting prior to the effective date of the Tax Reform Act of 1986. In addition, mixed service costs do not include costs ("policy service costs") that do not benefit the production activities of the taxpayer, but rather, benefit only the types of non-production activities described in paragraph (b)(4)(vii) of this section (*e.g.*, overall management or policy guidance functions). See paragraph (b)(4) of this section for explanations and illustrations of the types of mixed service costs that are required to be allocated among the production activities of the taxpayer.

(ii) *Availability.* The simplified service cost method of this paragraph (b)(6) may be used to determine the inventoriable mixed service costs with respect to the production of real or personal property that is:

(A) Stock in trade of the taxpayer or other property that is properly includable in the inventory of the taxpayer, or

(B) Property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

The simplified service cost method is not available with respect to property acquired for resale (except as provided in paragraph (b)(5)(i) of this section, relating to a single trade or business engaged in both production and resale activities). Moreover, the simplified service cost method is not available with respect to property constructed by a taxpayer for use in its trade or business, property produced under a long-term contract, or any other property produced by a taxpayer that is not described in section 1221(1) of the Internal Revenue Code. The inventoriable mixed service costs determined under the simplified service cost method shall generally be allocated to specific properties produced by the taxpayer in accordance with the rules relating to the allocation of indirect costs under paragraph (b)(3)(iii) of this section. If the taxpayer elects to use the simplified production method under paragraph (b)(5) of this section, then the inventoriable mixed service costs shall be allocated under that method.

(iii) *Determination of inventoriable portion.* (A) The inventoriable mixed service costs required to be capitalized with respect to the taxpayer's production activities shall be determined by multiplying the total mixed service costs incurred in the taxpayer's trade or business during the taxable year by the ratio of—

(*1*) The total production costs incurred in the taxpayer's trade or business under this section (excluding mixed service costs and interest) for the taxable year, to—

(*2*) The total of all costs incurred in the operation of the taxpayer's trade or business (excluding mixed service costs and interest) for the taxable year.

(B) For example, assume that Taxpayer A incurs $1,000 of mixed service costs in the taxable year. The total of A's production costs incurred for the taxable year, excluding mixed service costs and interest, is $10,000. The total costs incurred for all of A's operations (exclusive of mixed service costs and interest) for the taxable year is $20,000. The total inventoriable mixed service costs allocable to A's production activities is $500 for the taxable year *i.e.*, ($1,000 × ($10,000 divided by $20,000)).

(C) For purposes of this method, the cost of operations consists of all direct and indirect costs of production, and all other costs of the taxpayer's operations, including but not limited to salaries and other labor costs of all personnel, all depreciation taken for federal income tax purposes, research and experimental costs, and selling, marketing and distribution costs. Such costs of operations shall not include, however, federal, state, local or foreign income taxes (or taxes measured by income such as franchise taxes assessed on income).

(D) If (*1*) the taxpayer's mixed service costs, or (*2*) the total costs incurred in the taxpayer's operations, are allocable to more than one trade or business, then the taxpayer shall determine the amount allocable to a particular trade or business by using any reasonable method of allocation (consistently applied) otherwise permitted under this section.

(E) In determining the total mixed service costs incurred in a taxpayer's trade or business during the taxable year for purposes of the formula described in paragraph (b)(6)(iii)(A) of this section (the "allocation formula"), the taxpayer shall utilize the total costs of the various departments or functions in the taxpayer's trade or business that perform mixed service activities (*e.g.*, the departments or functions described in paragraph (b)(4)(x) of this section). The total costs of such departments or functions shall then be included for purposes of the allocation formula in determining the inventoriable mixed service costs that are required to be capitalized as production costs. For purposes of the simplified service cost method, it shall not be permissible to exclude policy service costs (or other non-production costs) which are otherwise included in the total costs of departments or functions performing mixed service activities, and then include only the remainder of the costs of such departments or functions for purposes of the allocation formula. For example, assume that the accounting department of the taxpayer performs mixed service activities pertaining to production and non-production activities. For purposes of the simplified service cost method, the costs of personnel in the accounting department that perform services relating to non-production activities (*e.g.*, accounts receivable clerks which only account for the selling activities of the taxpayer) are not permitted to be excluded from the mixed service costs incurred by the accounting department which are subject to the allocation formula. Instead, under the simplified service cost method, the entire cost of the accounting department shall be included for purposes of applying the allocation formula. Similarly, the labor costs of administrative and managerial personnel that are incurred with respect to both production and non-production activities shall be accounted for in the same manner, *i.e.*, the total costs of such personnel shall be included for purposes of applying the allocation formula, without first reducing such costs by the amounts therein pertaining to non-production activities.

(iv) *De minimis rule.* For purposes of the simplified service cost method of this paragraph (b)(6), the determination of whether service costs are to be treated as costs solely allocable to production ("production service costs") or as costs solely allocable to other non-production functions of the taxpayer such as functions relating to overall management and policy ("policy service costs"), is to be based on the predominant nature of such service costs. For purposes of this paragraph (b)(6)(iv), the predominant nature of a service cost shall be treated as solely allocable to a particular activity if 90 percent or more of that cost directly benefits or is incurred by reason of such activity. In such a case, the total of such costs shall be treated as allocable to such activity. For example, assume that 90 percent of the costs of a particular department directly benefit or are incurred by reason of the taxpayer's inventory production activities. For purposes of the simplified service cost method of this paragraph (b)(6), the taxpayer shall treat 100 percent of the costs of the department as if such costs are production service costs. Similarly, assume that 90 percent of the costs of a particular department directly benefit or are incurred by reason of the taxpayer's overall policy making activities. For purposes of the simplified mixed service cost method of this paragraph (b)(6), the taxpayer shall treat 100 percent of the costs of that department as policy service costs that are not required to be allocated to production.

(v) *Change in method of accounting.* The election to use the simplified service cost method shall be made separately for each trade or business of the taxpayer on a timely filed income tax return for the taxpayer's first taxable year for which this section becomes effective. For taxable years subsequent to such taxable year of the taxpayer, a change in method to, or from, the simplified service cost method requires the consent of the Commissioner.

(c) *Special rules for property produced in a farming business*—(1) *General rule.* In general, this section applies to property produced in a farming business if such property has a preproductive period of more than 2 years, or if such farming business is described in paragraph (c)(2) of this section. This section does not apply, however, if the property is described in paragraph (c)(3) of this section or if the taxpayer has made the election described in paragraph (c)(6) of this section. In addition, this section does not apply to animals produced in a farming business if such animals are held primarily for slaughter (regardless of the preproductive period of such animals), except that this section shall apply to the production of such animals by a farming business if such business is described in paragraph (c)(2) of this section. For purposes of this section, an animal is held primarily for slaughter regardless of whether the taxpayer itself will slaughter the animal or instead will sell the animal to others for slaughter.

(2) *Taxpayers required to use the accrual method.*

(i) This section applies to property produced in a farming business (including all animals held primarily for slaughter) without regard to the preproductive period of such property in the case of a:

(A) Corporation or partnership required to use an accrual method of accounting under section 447 in computing its taxable income from farming, or

(B) Tax shelter required to use an accrual method of accounting under section 448(a)(3).

Thus, for example, this section applies to an enterprise involving the feeding of cattle held for slaughter regardless of the preproductive period of such cattle, if the enterprise is required to use an accrual method of accounting under section 447 or section 448(a)(3).

(ii) For purposes of this section, a farming business shall be considered a tax shelter, and thus required to use an accrual method of accounting under section 448(a)(3), if that farming business is:

(A) A farming syndicate as defined in section 464(c); or

(B) A tax shelter within the meaning of section 6661(b)(2)(C)(ii), defined as—

(*1*) A partnership or other entity,

(*2*) Any investment plan or arrangement, or

(*3*) Any other plan or arrangement, if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax.

(iii) For purposes of this section, marketed arrangements in which persons carry on farming activities utilizing the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance if such persons prepay a substantial portion of their farming expenses with borrowed funds.

(3) *Exception*—(i) *In general.* This section does not apply to costs incurred on or after October 22, 1986, that are attributable to the replanting, cultivation, maintenance, and development of any plants bearing an edible crop for human consumption (including, but not limited to, plants which constitute a grove, orchard, or vineyard) that were lost or damaged while in the hands of the taxpayer by reason of freezing temperatures, disease, drought, pests, or casualty. Such replanting or maintenance costs may be incurred with respect to property other than the property on which the damage or loss occurred if the acreage of the property with respect to which the replanting or maintenance costs are incurred is not in excess of the acreage of the property on which the damage or loss occurred. Plants bearing crops for human consumption are those crops that are normally eaten or drunk by humans. Thus, for example, costs incurred with respect to replanting plants bearing jojoba beans do not qualify for the exception provided in this paragraph (c)(3)(i) because that crop is not normally eaten or drunk by humans.

(ii) *Ownership; in general.* Replanting, cultivation, maintenance, and development costs described in paragraph (c)(3)(i) of this section generally must be incurred by the taxpayer owning the property at the time the plants were lost or damaged. Paragraph (c)(3)(i) of this section will apply, however, to costs incurred by a person other than the taxpayer owning the plants at the time of damage or loss if—

(A) The taxpayer who owned the plants at the time the damage or loss occurred owns an equity interest of more than 50 percent in such plants or crops, and

(B) Such other person owns any portion of the remaining equity interest and materially participates in the replanting, cultivating, maintenance or development of such plants or crops.

A person will be treated as materially participating for purposes of this provision if such person would otherwise meet the requirements with respect to material participation within the meaning of section 2032A of the Code.

(4) *Definitions*—(i) *Farming business.* (A) For purposes of this section, a farming business means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples include the trade or business

of operating a nursery or sod farm; the raising or harvesting of crops; the raising or harvesting of trees bearing fruit, nuts or other crops; the raising of ornamental trees; and the raising, shearing, feeding, caring for, training, and management of animals.

(B) For purposes of this section, an evergreen tree that is more than 6 years old at the time it is severed from its roots is not treated as an ornamental tree regardless of the purpose for which it is sold.

(C) For purposes of this section, the term "farming business" does not include the processing of commodities or products beyond those activities which are normally incident to the growing, raising or harvesting of such products. Thus, for example, assume the taxpayer, a C corporation, is in the business of growing and harvesting wheat and other grains. The taxpayer processes grains which it has harvested in order to produce breads, cereals, and other similar food products which it then sells to customers in the course of its business. Although the taxpayer is in the farming business with respect to the growing and harvesting of grain, the taxpayer is not in the farming business with respect to the processing of such grains to produce food products which it sells to customers. Similarly, assume the taxpayer is in the business of raising poultry or other livestock. The taxpayer then uses such livestock in a meat processing operation in which the livestock are slaughtered, processed, and packaged or canned in preparation for their sale to customers. Although the taxpayer is in the farming business with respect to the raising of livestock, the taxpayer is not in the farming business with respect to the meat processing operation.

(ii) *Preproductive period.* (A) For purposes of this section, the preproductive period of property produced in a farming business means—

(*1*) In the case of a plant or animal which will have more than one crop or yield, the period before the first marketable crop or yield from such plant or animal, or

(*2*) In the case of any other plant or animal, the period before such plant or animal is reasonably expected to be disposed of.

(B) The preproductive period of a plant begins when the plant or seed is first planted or acquired by the taxpayer. The preproductive period ends when the plant becomes productive in marketable quantities or when the plant is reasonably expected to be sold or otherwise disposed of.

(C) The preproductive period of an animal begins at the time of acquisition, breeding, or embryo implantation. The preproductive period ends at the time the animal is ready to perform the primary function intended to be performed by that animal (*e.g.*, when the animal becomes productive in marketable quantities), or when the animal is reasonably expected to be sold or otherwise disposed of. For example, in the case of a cow used for breeding purposes, the preproductive period with respect to the cow ends on the date the first calf is dropped.

(D) The preproductive period of plants grown in commercial quantities in the United States shall be based on the weighted average preproductive period for such plant, determined on a nationwide basis.

(5) *Inventory methods*—(i) *In general.* Except as otherwise provided, the costs required to be allocated to any plant or animal under this section may be determined using reasonable inventory valuation methods such as the farm-price method or the unit-livestock-price method. See section 1.471-6.

(ii) *Availability to tax shelters.* Tax shelters, as defined in paragraph (c)(2)(i)(B) of this section, using the unit-livestock-price method of accounting for inventories must include in inventory the annual standard unit price for all animals which are acquired during the taxable year, regardless of whether such purchases are made during the last 6 months of the taxable year.

(6) *Election not to have this section apply.*—(i) *Introduction.* This paragraph (c)(6) permits certain taxpayers to make an election not to have the rules of this section apply to any plant or animal produced in a farming business conducted by the electing taxpayer.

(ii) *Availability of the election.* The election described in this section is available to any farmer except that no election may be made by a corporation, partnership or tax shelter required to use an accrual method of accounting under section 447 or 448(a)(3). Moreover, no election may be made with respect to the planting, cultivation, maintenance or development of pistachio trees. In addition, the election described in this section does not apply to any costs incurred for the planting, cultivation, maintenance or development of any citrus or almond grove (or any part thereof) to the extent that such costs are incurred within the first four years in which such trees were planted. If a citrus or almond grove is planted in more than one taxable year, the portion of the grove planted in any one taxable year is treated as a separate grove for purposes of determining the year of planting.

(iii) *Time and manner of making the election.* Unless consent is obtained from the Commissioner, the election described in this section may only be made for the taxpayer's first taxable year that begins after December 31, 1986, and during which the taxpayer engages in a farming business. The election shall be made on the schedule E, F, or other schedule required to be attached to the income tax return for the first taxable year for which the election is effective. In the case of a partnership or S corporation, the election must be made by the partner or shareholder.

(iv) *Election treated as if made if certain requirements satisfied.* A taxpayer eligible to make the election under paragraph (c)(6) of this section shall be treated as having made the election if such taxpayer does not capitalize the costs of producing property in a farming business as the provisions of this section would otherwise require.

(v) *Revocation.* Once the election is made, it is revocable only with the consent of the Commissioner.

(vi) *Special rules for treatment of expenses.* (A) If the election is made, the plant or animal produced by the taxpayer is treated as section 1245 property and any gain resulting from any disposition of such property is recaptured (*i.e.*, treated as ordinary income) to the extent of the total amount of the deductions which, but for the election, would have been required to be capitalized with respect to the plant or animal. In calculating the amount of gain which is recaptured under this paragraph (c)(6)(vi), the taxpayer may use the farm-price or unit-livestock methods in determining the deductions which otherwise would have been capitalized with respect to the plant or animal.

(B) If the taxpayer or a related person makes the election, the alternative depreciation system (as defined in section 168(g)(2)), shall be applied to all property used predominantly in any farming business of the taxpayer or related person and placed in service in any taxable year during which the election is in effect. The requirement to use the alternative depreciation system by reason of any election under paragraph (c)(6) of this section shall not prevent any taxpayer from making an election under section 179 to expense certain depreciable business assets.

(C) For purposes of this paragraph (c)(6), the term "related party" means—

(*1*) The taxpayer and members of the taxpayer's family (defined, for this purpose, to include the spouse of the taxpayer and any of his or her children who have not reached the age of 18 as of the last day of the taxable year in question),

(*2*) Any corporation (including an S corporation) if 50 percent or more of the stock (in value) is owned directly or indirectly (through the application of section 318) by the taxpayer or members of the taxpayer's family,

(*3*) A corporation and any other corporation which is a member of the same controlled group (within the meaning of section 1563(a)(1)), and,

(*4*) Any partnership if 50 percent or more (in value) of the interests in such partnership is owned directly or indirectly (through the application of section 318) by the taxpayer or members of the taxpayer's family.

(vii) The operation of the election not to have this section apply is illustrated in the following examples:

Example (1) Assume that A, an individual, is engaged in the trade or business of farming. A raises cattle for breeding and dairy purposes. In addition, A grows and harvests wheat and other grains. Assume further, that the preproductive period of certain of the cattle raised by A is more than two years, as defined in paragraph (c)(4)(ii) of this section, and that A elects under paragraph (c)(6) of this section not to have the rules of this section apply to the costs of raising such cattle. A is required to use the alternative depreciation system described in section 168(g) of the Code with respect to all property used predominantly in any farming business of A (including the growing and harvesting of wheat) if such property is placed in service during a year for which the election is in effect. Thus, for example, all assets and equipment (including any dairy cattle which A treats as depreciable property, and any equipment used to grow and harvest wheat) placed in service during a year for which the election is in effect must be depreciated using the straight line method over the applicable number of years, as provided in section 168(g).

Example (2) Assume the same facts as in example 1, except that A and members of A's family (as defined in paragraph (c)(6)(vi)(C)) also own 51% (in value) of the interests in a partnership P, which is engaged in the trade or business of growing and harvesting corn. P is a related person to A under the provisions of paragraph (c)(6)(i)(F) of this section. Thus, the requirements to use the alternative depreciation system under section 168(g) also apply to any property used predominantly in a trade or business of farming which P places in service during a year for which the election made by A is in effect.

(d) *Definitions and special rules relating to property acquired for resale*—(1) *General rule*—(i) Unless an election is made to use the simplified resale method provided in paragraph (d)(3) of this section, the rules of this section applicable to the production of property shall apply to costs incurred with respect to property acquired for resale in a trade or business or activity conducted for profit. For purposes of this section, property acquired for resale includes stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. Property acquired for resale may be real property or personal property (whether such personal property is of a tangible or intangible nature). Thus, property held for sale may include—

(A) Literary, musical or artistic compositions; stocks, certificates, notes, bonds, debentures, or other evidence of indebtedness;

(B) An interest in, or right to subscribe to or purchase any of the foregoing; and

(C) Other intangible properties.

Thus, for example, a dealer in securities must properly capitalize costs, as required by this section, with respect to the securities acquired by the dealer for resale.

(ii) Any taxpayer that does not elect to use the simplified resale method with respect to property acquired for resale, shall capitalize the costs which are required to be capitalized in paragraph (d)(3)(ii) of this section with respect to such method, using the definitions of such costs as are provided therein. Thus, for example, taxpayers not electing to use the simplified resale method shall be required to capitalize offsite storage costs, as defined under the simplified resale method; moreover, the definition of distribution costs as provided under the simplified resale method shall apply to such taxpayers as well.

(iii) Taxpayers not electing the use of the simplified resale method may not utilize the various allocation methods or expedited procedures provided under such method, but rather must use such methods and procedures as are allowed with respect to the production of property under this section. Thus, for example, in determining the total amount of general and administrative expenses allocable to offsite storage, purchasing, and handling costs, such taxpayers shall not use the fraction for allocating such expenses which is based on labor costs incurred in the various activities, unless such method would be otherwise allowed to producers of property. Similarly, in determining the costs which are attributable to purchasing activities, such taxpayers shall not use the procedure provided in the simplified resale method whereunder certain activities may be disregarded if they comprise less than one-third of the aggregate activities being performed.

(2) *Exception for taxpayers with gross receipts of $10 million or less*—(i) *In general.* This section does not apply in the case of personal property acquired for resale by a taxpayer whose average annual gross receipts (determined under this paragraph (d)(2)) for the 3 taxable years preceding the taxable year (or, if less, the number of preceding taxable years the taxpayer and any predecessor has been in existence) do not exceed $10 million. This section does apply, however, in the case of real property acquired for resale by a taxpayer, regardless of the taxpayer's gross receipts.

(ii) *Aggregation of gross receipts.* For purposes of determining the gross receipts of the taxpayer, all persons treated as a single employer under section 52 (a) or (b), or section 414 (m) or (o) shall be treated as one person. Thus, gross receipts attributable to transactions between such persons treated as a single employer shall not be taken into account for purposes of this provision.

(iii) *Treatment of short taxable year.* In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts shall be annualized by (A) multiplying the gross receipts for the short taxable year by 12, and (B) dividing the result by the number of months in the short taxable year.

(iv) *Determination of gross receipts*—(A) *In general.* The term "gross receipts" means the total amount, as determined under the taxpayer's method of accounting, received from all trades or businesses carried on by the taxpayer (e.g., revenue derived from the sale of inventory before reduction for cost of goods sold).

(B) *Amounts excluded.* For purposes of this paragraph (d)(2), gross receipts shall not include amounts representing—

(*1*) Returns or allowances,

(*2*) Interest, dividends, rents, royalties, or annuities, not derived in the ordinary course of a trade or business,

(*3*) Receipts from the sale or exchange of capital assets, as defined in section 1221, and

(*4*) Receipts from sales or exchanges not in the ordinary course of business, such as the sale of a trade or business, or the sale of property used in a trade or business as defined under section 1221(2).

(3) *Simplified method of accounting for resale costs*—(i) *In general.* Except as otherwise provided, taxpayers may elect to use the simplified method of this paragraph (d)(3) (the "simplified resale

method") for allocating costs to property acquired for resale. The simplified resale method must be applied separately to each trade or business of the taxpayer. (See paragraph (b)(5) of this section which provides that only the simplified production method and not the simplified resale method shall be available in the case of a single trade or business that consists of both production and resale activities.) Under the simplified resale method, preliminary inventory balances are to be calculated without the inclusion of the additional costs required to be allocated in paragraph (d)(3)(ii) of this section. The amount of additional costs attributable to prior periods and the amount of additional costs determined to be allocable under paragraph (d)(3)(ii) of this section for the current period are then taken into account with the inventory balances as initially calculated in order to arrive at an ending inventory balance.

(ii) *Costs required to be capitalized.* The following categories of costs are required to be capitalized with respect to property acquired for resale, regardless of whether a taxpayer elects the simplified resale method. This paragraph (d)(3)(ii) provides illustrative examples of particular items of cost which are required to be capitalized under this section. For example, costs of handling generally consist of direct and indirect labor costs, tools, vehicles, and other enumerated items. These examples are not exhaustive in nature; to the extent that other particular items of costs incurred by the taxpayer benefit or are incurred by reason of the particular activity in question, such costs shall be capitalized accordingly.

(A) *Off-site storage or warehousing*—(*1*) *Definition.* Costs attributable to the operation of off-site storage or warehousing facilities ("off-site storage facilities") under this section are required to be capitalized with respect to inventory. For purposes of this section, an off-site storage facility is defined as any storage or warehousing facility which is not an on-site storage facility. An on-site storage facility is a facility which is physically attached to, and an integral part of, a retail sales facility where the taxpayer sells merchandise stored at the facility to customers physically present at the facility ("on-site sales"). Thus, for example, a catalog or mail order center which stores merchandise for shipment to customers who purchase such merchandise through orders placed over the telephone, or orders delivered in the mail, is not an on-site storage facility, and thus is treated as an off-site storage facility. Similarly, a "pooled stock facility" which functions as a "back-up" regional storage facility for particular retail sales outlets in the nearby area is not an on-site storage facility, and is thus treated as an off-site storage facility. Moreover, a storage or warehousing area operated by a person mailing sales of goods "wholesale" to persons who in turn resell the goods to others, is not an on-site storage facility because such facility is not an integral part of a retail sales facility.

(*2*) *Dual-function facilities.* Except as provided in paragraph (d)(3)(ii)(A)(*3*) of this section, if a storage facility serves as both an on-site and off-site storage facility, a percentage of the facility shall be treated as an on-site storage facility equal to the ratio of—

(*i*) Gross on-site sales of the facility, i.e., gross sales of the facility made to retail customers visiting the premises in person and purchasing merchandise stored therein, to—

(*ii*) Total gross sales of the facility. The portion of the facility which is not treated as an on-site facility under the preceding sentence shall be treated as an off-site facility. For example, assume a catalog center conducts on-site sales which are equal to 40 percent of the total sales made by the facility. For purposes of this section, 40 percent of the facility shall be viewed as an on-site storage facility; the remaining 60 percent shall be viewed as an off-site storage facility.

(*3*) *De minimis rule for dual function facilities.* If 10 percent or less of the gross sales of a facility are attributable to on-site sales, then the entire storage facility located at the site shall be deemed to be an off-site storage facility for purposes of this section. If, in contrast, 90 percent or more of the gross sales of a facility are attributable to on-site sales, then the entire storage facility located at the site shall be deemed to be an on-site storage facility.

(*4*) *Allocation of costs; off-site facilities.* To the extent that costs are incurred at an off-site storage facility which do not directly benefit, or are not incurred by reason of, the storage functions of such facility, then such costs shall not be accounted for as costs of an off-site facility. Thus, for example, assume that a catalog store incurs costs (e.g., labor cost of clerical personnel) attributable to receiving and processing customer orders which will be filled by directly shipping the merchandise to the customer's address. Costs attributable to these functions will be treated as costs allocable to the selling function of the taxpayer's business, and thus not treated as off-site storage costs.

(*5*) *Costs attributable to off-site facilities.* Cost attributable to an off-site storage facility generally consist of direct and indirect labor costs (including the costs of pension plans and other "fringe benefits" as described in paragraphs (b)(2) (ii) and (iii) of this section); occupancy expenses including rent, depreciation, insurance, security, taxes, utilities and maintenance; materials and supplies; tools and equipment; and, general and administrative costs that directly benefit or are incurred by reason of the off-site storage activities of the taxpayer.

(B) *Purchasing.* (*1*) Costs attributable to purchasing activities under this section are required to be capitalized with respect to inventory. Purchasing activities include functions associated with a purchasing department or office, and personnel such as buyers, assistant buyers, and clerical workers, whose function relates to the activities of the selection of merchandise, maintenance of stock assortment and volume, placement of purchase orders, establishment and maintenance of vendor contacts, or comparison and testing of merchandise.

(*2*) The determination of whether a person is engaged in purchasing activities shall be based upon the actual activities performed by such person and not upon that person's title or job classification. Thus, for example, although a particular employee may be described as a "buyer" in the employer's job classification system, activities performed by such person shall not be considered as purchasing activities unless such treatment is appropriate based on an analysis of the actual responsibilities of the employee.

(*3*) Similarly, although a person's job function may be described in such a way as to denote activities outside the area of purchasing (e.g., a "marketing representative"), such activities shall be accounted for under this section as purchasing activities if such treatment is appropriate based upon an analysis of the actual responsibilities of the employee.

(*4*) *In general.* (*i*) If a person performs more than one function, a reasonable allocation of the labor costs attributable to such person shall be made between the purchasing and non-purchasing functions of such person.

(*ii*) For purposes of this paragraph (d)(3)(ii)(B)(*4*), the following formula may be applied by a taxpayer with respect to all personnel directly performing purchasing functions in a trade or business in allocating the labor costs of such personnel to the functions of the taxpayer. (This formula may not be used with respect to personnel providing general and administrative services which benefit or are incurred by reason of purchasing functions).

(*A*) If less than one-third of a person's activities relate to a purchasing function, none of the labor costs attributable to that person shall be allocated to a purchasing function.

(*B*) If more than two-thirds of a person's activities relate to a purchasing function, all of the labor costs attributable to that person shall be allocated to a purchasing function.

(*C*) In all other cases, an allocation of costs between functions must be made.

(*iii*) For example, assume that A, B, and C are employed by taxpayer M in a retail business. Employee A performs activities, 25 percent of which are direct purchasing functions. Employee B performs activities, 70 percent of which are direct purchasing functions. Employee C performs activities, 50 percent of which are direct purchasing functions. As a result of the application of the formula provided in this paragraph, M will treat none of the labor costs of employee A as allocable to purchasing costs; all of the labor costs of employee B as allocable to purchasing costs; and 50 percent of the labor costs of employee C as allocable to purchasing costs and 50 percent as allocable to nonpurchasing labor costs.

(*5*) Costs attributable to purchasing activities generally consist of direct and indirect labor costs (including the costs of pension plans and other "fringe benefits" as described in paragraphs (b)(2) (ii) and (iii) of this section), office machines, supplies, telephone, travel, and the general and administrative costs that directly benefit or are incurred by reason of the purchasing activities of the taxpayer.

(C) *Handling, processing, assembly, and repackaging*—(*1*) *Definition.* Costs attributable to handling, processing, assembly, repackaging and other similar activities ("handling costs") under this section are required to be allocated to inventory. Handling costs include, for example, all costs incurred in transporting goods (including loading and unloading costs):

(*i*) From the place of purchase to the taxpayer's storage facility (to the extent not already capitalized by the taxpayer),

(*ii*) From storage facility to storage facility, and

(*iii*) From a storage facility to a store or outlet where the sale of the delivered item occurs. Similarly, handling costs include the costs of processing, assembling, and repackaging goods. To the extent that such processing activities would be required, under the law prior to the effective date of the Tax Reform Act of 1986, to be accounted for as the costs of manufactured inventory under section 1.471–11, then the taxpayer shall account for such costs under the rules applicable to production of property rather than the rules of this paragraph (d)(3). (Also, see paragraph (b)(5) of this section for rules relating to the simplified method available for a single trade or business that consists of both production and resale activities).

(*2*) *Exception for repackaging costs after sale occurs.* For the purpose of this paragraph (d)(3), handling costs shall not include the costs of repackaging goods in preparation for imminent shipment or delivery directly to a particular customer, if such repackaging occurs after the customer has ordered the specific identifiable goods in question.

(*3*) *Exception for distribution costs.* For the purpose of this paragraph (d)(3), handling costs shall not include distribution costs. Distribution costs are defined as the costs of delivering goods directly to the customer, e.g., costs incurred in delivering an item from a storage facility to a customer's home. Except as provided in paragraph (d)(3)(ii)(C)(*4*) of this section, distribution costs do not include costs of transporting an item from a storage facility to a store or outlet where the sale of the item occurs.

(*4*) *Custom delivery of ordered items.* Costs incurred in delivering goods from a storage facility to a store where the sale of the goods occurs are presumed to be handling costs allocable to the property and not distribution costs incurred for delivery of goods directly to the customer. This presumption can be overcome only if the taxpayer can demonstrate that a delivery to the store or other selling location is made to fill an identifiable order of a particular customer (placed by such customer before the delivery of the goods occurs) for the particular goods in question. Factors that may demonstrate the existence of a specific, identifiable delivery include the following:

(*i*) The customer has paid for the item in advance of delivery;

(*ii*) The customer has submitted a written order for the item;

(*iii*) The item is not normally available at the retail store for on-site customer purchases; or

(*iv*) The item will be returned to the storage facility (and not held for sale at the store or selling location) if the customer cancels an order.

(*5*) *Costs attributable to handling.* The costs attributable to handling activities generally consist of direct and indirect labor (including the costs of pension plans and other fringe benefits as described in paragraphs (b)(2) (ii) and (iii) of this section); tools; vehicles and equipment; maintenance of vehicles and equipment; rent, depreciation, and insurance of vehicles and equipment; materials; supplies; and the general and administrative costs that directly benefit or are incurred by reason of such activities of the taxpayer.

(D) *General and administrative expenses.* A portion of direct and indirect costs incurred by any administrative, service or support functions or departments ("service departments"), that directly benefits or is incurred by reason of both off-site storage, purchasing, or handling activities, as defined in this section, and the taxpayer's other activities ("mixed service costs") is to be included in inventory costs under this paragraph (d)(3)(ii)(D). The determination of the aggregate portion of such mixed service costs required to be allocated to the off-site storage, purchasing, and handling activities described in this paragraph (d)(3) is to be made pursuant to the rules contained in paragraph (d)(4) of this section.

(4) *Allocation methods under the simplified resale method*—(i) *In general.* The costs that are incurred with respect to the categories described in paragraph (d)(3)(ii) of this section (i.e., activities pertaining to off-site storage, purchasing, handling, and mixed service costs) ("additional section 263A resale costs") are to be allocated to inventory in the manner provided in this paragraph (d)(4). In making all computations under this paragraph (d)(4), initial inventory balances shall be determined without regard to any additional section 263A resale costs allocated under this paragraph (d)(4).

(ii) *Offsite storage, purchasing and handling costs—In general.* The additional section 263A resale costs of the taxpayer for the taxable year are to be allocated to inventory based on the ratio of such costs to the taxpayer's purchases for the year (the "allocation ratio"). The taxpayer shall determine the additional section 263A resale costs to be capitalized in ending inventory by multiplying the allocation ratio times the amounts in the taxpayer's ending inventory which are treated as purchases made during the current year under the taxpayer's method of accounting. Taxpayers will initially calculate their inventory balances without regard to the additional costs required to be capitalized under paragraph (d)(3)(ii) of this section. Taxpayers will then determine the amounts of additional section 263A resale costs that must be capitalized under this paragraph (d)(4)(ii) of this section, and take into account such amounts, along with amounts of additional costs contained in beginning inventory balances where appropriate, with the preliminary inventory balances to determine their final balances.

(iii) *Determination of mixed service costs*—(A) *In general.* The amount of mixed service costs which is to be included as additional section 263A costs for purposes of calculating the allocation ratio as provided in paragraph (d)(4)(ii) of this section is determine in the following manner. The amount of mixed service costs which is included in additional section 263A resale costs shall be determined by multiplying the total amount of mixed service costs incurred by the taxpayer in the trade or business for the taxable year, by the ratio of—

(*1*) The sum of the labor costs allocable to the off-site storage, purchasing, and handling activities, described in paragraph (d)(3)(ii) of this section, to—

(*2*) The total of all labor costs incurred in the taxpayer's trade or business, excluding the total amount of labor costs included in the mixed service costs incurred by the taxpayer in the trade or business for the taxable year.

To the extent that mixed service costs and labor costs are incurred in more than one trade or business, the taxpayer shall determine the amounts allocable to the particular trade or business in issue by using any reasonable method consistent with the principles of this section.

(B) *Example.* The determination of mixed service costs under this provision is illustrated by the following example.

Example. Taxpayer T incurs $1 million in mixed service costs in its trade or business for the taxable year. The labor costs allocable to T's purchasing, handling and off-site storage activities are $5 million. The labor costs of T's trade or business as a whole (including the labor costs allocable to purchasing, handling and off-site storage activities, but excluding the labor costs contained in the $1 million in mixed service costs) are $25 million. The mixed service costs that T must treat as additional section 263A resale costs are equal to $200,000 (*i.e.*, $5 million divided by $25 million, multiplied by $1 million). The $200,000 in mixed service costs are included in additional section 263A resale costs, and are allocated to ending inventory using the procedures described in paragraph (d)(4)(ii) of this section.

(C) In determining whether the costs of a department or function are mixed service costs under this paragraph (d)(4)(iii), the taxpayer shall apply the principles contained in paragraph (b)(6) of this section relating to the simplified mixed service cost method applicable to the production of inventory. Thus, for example, the taxpayer shall apply the de minimis rule described in paragraph (b)(6)(iv) of this section in determining whether service costs are solely allocable to resale activities, or whether service costs are solely allocable to non-resale activities. Moreover, the taxpayer shall apply the principles of paragraph (b)(6)(iii)(E) of this section in determining the total costs of departments or functions which are to be included as mixed service costs under this paragraph (d)(4)(iii). Thus, for example, in determining the total costs of departments or functions performing mixed service activities for purposes of this paragraph (d)(4)(iii), the taxpayer shall not exclude non-resale related costs which are otherwise included in the total costs of such departments performing mixed service activities. See the examples relating to the costs of an accounting department and the labor costs of administrative and managerial personnel which are contained in paragraph (b)(6)(iii)(E) of this section.

(iv) *Examples.* The application of the simplified resale method is illustrated in the following examples:

Example (1). Taxpayer A, using the first-in, first-out (FIFO) method of accounting for inventories, incurred $400,000 of storage costs, $500,000 of purchasing costs, $300,000 in handling and processing costs, and $200,000 of mixed service costs during the taxable year (a total of $1.4 million in additional section 263A resale costs). A's beginning inventory balance (excluding additional section 263A resale costs) was $2 million. A made $8 million in gross purchases during the taxable year, and A's ending inventory (excluding additional section 263A resale costs) was $3 million. The amounts in ending inventory which are viewed as consisting of purchases made during the year, under the FIFO method, are $3 million. The ratio of additional section 263A resale costs to purchases made during the taxable year (the allocation ratio) is 17.5 percent *i.e.*, $1.4 million divided by $8 million. The additional section 263A resale costs required to be capitalized in ending inventory are equal to $525,000, i.e., the product of the allocation ratio (17.5 percent) multiplied by the amount of purchases for the year which are viewed as being held in ending inventory ($3,000,000).

Example (2). Taxpayer B uses the last-in, first-out method (LIFO) of accounting for inventories. Assume the same facts as Example (1). The amounts in ending inventory which are viewed as consisting of purchases made during the taxable year, under the LIFO method, are $1 million. The ratio of additional section 263A resale costs to purchases made during the taxable year is 17.5 percent. The additional section 263A resale costs required to be capitalized in ending inventory are equal to $175,000, i.e., the product of the allocation ratio (17.5 percent) multiplied by the amount of purchases for the year which are viewed as being held in ending inventory ($1,000,000).

Example (3). Taxpayer X begins its trade or business in Year 1, and uses the LIFO method of accounting for inventories. X had no beginning inventory balance for the year (due to entering the trade or business in Year 1). X incurred a total of $1,000 in additional section 263A resale costs in Year 1, and maue $10,000 in gross purchases. The amounts in ending inventory which are viewed as consisting of purchases made during the taxable year, under the LIFO method, are $3,000. Such ending inventory amounts are contained in pools A, B, and C. X allocates its additional section 263A resale costs for Year 1 as follows:

Year 1

Additional section 263A resale costs, $1,000 divided by Purchases, $10,000 equals 10% allocation ratio

	Total	A	B	C
Year 1				
Ending balance	$3,000	$1,600	$600	$800
Allocation ratio	.10	.10	.10	.10
Current additional section 263A costs	300	160	60	80
Final ending inventory bala..e	3,300	1,760	660	880

In Year 2, X incurs $400 of additional section 263A costs. Purchases for Year 2 are $2,000, distributed among pools A, B, and C. Cost of sales for Year 2 are $1,000. X computes its final inventory for Year 2 as follows:

Year 2

Additional section 263A costs, $400 divided by Purchases, $2,000 equals 20% allocation ration

	Total	A	B	C
Year 2				
Beginning balance	$3,000	$1,600	$600	$800
Current purchases	2,000	1,500	300	200
Costs of sales	91,000	(300)	(300	(400)
Ending balance	4,000	2,800	600	600
Prior penod additional section 263A costs	300	160	60	80
Included in costs of sales	(20)			(20)
Remaining additional section 263A costs	280	160	60	60
Current additional section 263A costs	240	240		
Final ending inventory balance	4,520	3,200	660	660

Pool C is reduced by $200 in Year 2. A portion of the additional 263A resale costs contained in pool C which is attributable to Year 1 must be included in cost of goods sold in Year 2. The amount is determined by dividing the decrement in pool C by the total costs accumulated in the Year 1 layer of pool C; the resulting fraction is then multiplied by the additional section 263A costs contained in pool C that are attributable to Year 1. Thus, the amount of additional section 263A costs that is included in cost of goods sold from pool C, attributable to Year 1, is $20, *i.e.*, $200 divided by $800, multiplied by $80.

(v) *LIFO indexes.* Under the simplified resale method, a taxpayer using the LIFO method of accounting for inventories must calculate each particular year's index without regard to the additional section 263A resale costs required to be allocated under this section. Similarly, the taxpayer shall disregard the additional section 263A resale costs in adjusting current year costs by the appropriate indexes, in determining whether there has been an inventory increment or decrement for the current year in question for the particular pool. If the taxpayer determines that there has been an inventory increment, then the taxpayer shall state the amount of the increment in current year dollars, and then multiply the resulting amount by the allocation ration, as previously described. The resulting product is equal to the amount of the additional section 263A resale costs which the taxpayer is required to capitalize in ending inventory. If the taxpayer determines that there has been an inventory decrement, then the taxpayer shall state the amount of the decrement in dollars applicable to the particular year for which the LIFO cost or layer has been invaded. The additional section 263A resale costs incurred in prior years which are applicable to the decrement shall be charged to cost of goods sold. The additional section 263A resale costs which are applicable to the decrement are determined by multiplying the total amount of such section 263A resale costs allocated to the layer of the particular pool in which the decrement occurred, by the ratio of the decrement to the total costs (excluding section 263A resale costs) in the layer for such pool.

(5) *Section 481 (a) adjustment.* Taxpayers using the simplified resale method to allocate costs must apply the simplified method in revaluing their inventories for purposes of the change in method of accounting required under this section. See paragraph (e) of this section for rules relating to the methods permitted for inventory revaluations and the calculation of the adjustment under section 481(a).

(6) *Election.* The election to use the simplified resale method shall be made separately for each trade or business of the taxpayer on a timely filed income tax return for the taxpayer's first taxable year for which this section becomes effective beginning after December 31, 1986. For taxable years subsequent to such taxable year of the taxpayer, and election to use the simplified resale method requires the consent of the Commissioner. In addition, taxpayers are required to obtain the consent of the Commissioner to change from the simplified resale method to the general method of this section.

(e) *Inventories.* (1) *In general.* Under this section, taxpayers are required to change their method of accounting with respect to inventory property, effective for taxable years beginning after December 31, 1986. The required change in method of accounting applies to inventory produced by the taxpayer, as well as to inventory acquired by the taxpayer for resale. The change in method of accounting is to be made by revaluing the items or costs included in beginning inventory in the year of change as if the new capitalization rules of section 263A and this section has been in effect during all prior periods. In revaluing inventory costs under this procedure, all of the capitalization provisions of this section (*e.g.*, the requirement to capitalize the entire amount of tax depreciation and cost recovery allowances with respect to equipment and facilities), shall apply to all inventory costs accumulated in prior periods. The necessity to revalue beginning inventory as if the new capitalization rules had been in effect for all prior periods includes, for example, the revaluation of costs or layers incurred in taxable years preceding the transition period to the full absorption method of inventory costing as described in § 1.471–11(e), regardless of whether a taxpayer employed a "cut-off" method under those regulations. The difference between the inventory as originally valued and the inventory as revalued by applying the new capitalization rules is equal to the amount of the ajustment required under section 481(a). For example, with respect to inventories of films, sound recordings, video tapes, books, and other similar property, the taxpayer shall revalue the costs of such items (including, for example, the costs of a copyright and manuscript of a book) under the principles of this paragraph (e)(1).

(2) *Section 481(a) adjustment.* In the case of any taxpayer required by this section to change its method of accounting for any taxable year, such change shall be treated as initiated by the taxpayer. (In addition, such change shall be treated as made with the consent of the Commissioner, subject to the provisions of paragraph (e)(11) of this section). Thus, for example, the adjustment required under section 481(a) with respect to the change in method of accounting for such taxpayer shall not be reduced in any manner by any amount pertaining to taxable years preceding the effective date of the Internal Revenue Code of 1954. The adjustment arising from the change in method of accounting is to be taken into account over a period not to exceed 4 years.

(3) *Timing of section 481(a) adjustment.* (i) Any taxpayer required to change its method of accounting under this section shall take into account the adjustment required under the administrative procedures applicable to a voluntary change in method of accounting in effect on January 1, 1987, subject to the following modifications:

(ii) If 75 percent or more of the section 481(a) adjustment is attributable to the 1-taxable year period, 2-taxable year period, or 3-taxable year period immediately preceding the year of change, the highest percent attributable to the 1, 2, or 3-taxable year period is to be taken into account ratably over a 3-taxable year period beginning with the year of change. The remaining balance is to be taken into account in the 4th taxable year (the "75 percent rule"). The 75 percent rule of this paragraph shall only apply if the taxpayer has used its present method of accounting for more than 3 taxable years.

(iii) If paragraph (e)(3)(ii) of this section does not apply, the section 481(a) adjustment is to be taken into account ratably over the number of tax years (not to exceed 4) the taxpayer has used its present method of accounting.

(iv) If the taxpayer is a cooperative within the meaning of section 1381(a), the section 481(a) adjustment may be taken into account entirely in the year of change or, at the taxpayer's election, may be taken into account under the general procedures applicable to other taxpayers, as modified by the rules of this paragraph.

(v) The use of the expedited procedure described in pargraph (e)(4) of this section may be elected by a taxpayer in applying the 75 percent rule described in paragraph (e)(3)(ii) of this section.

(vi) Any net operating loss and tax credit carryforwards will be allowed to offset any positive section 481(a) adjustment.

(vii) For purposes of determining estimated tax payments, the section 481(a) adjustment will be recognized in taxable income ratably throughout the year in question.

(4) *Expedited procedure for applying the 75-percent rule.* (i) *In general.* Any taxpayer required to change its method of accounting under this section may elect to use the expedited procedure of this paragraph (e)(4)(i) in determining the appropriate period for taking into account the section 481(a) adjustment under the provisions of the 75-percent rule contained in paragraph (e)(3)(ii) of this section. Under the 75-percent rule, the period for taking the section 481(a) adjustment into account may be accelerated if 75 percent or more or the adjustment is attributable to either the 1-taxable year period, 2-taxable year period, or 3-taxable year period immediately preceding the year of change. In order to determine whether the 75-percent rule applies to a taxpayer, the taxpayer is required to compute the section 481(a) adjustment which would have been required had the change in method of accounting occurred in each of the three years preceding the actual year of change. Under the procedure provided in this paragraph (e)(4), in computing the amount of the section 481(a) adjustment that would have been required in the three taxable years preceding the year of change, a taxpayer may—

(A) Compute the percentage increase in the balance of beginning inventory resulting from the change in method of accounting for the taxable year beginning after December 31, 1986, and

(B) Multiply that percentage increase by the beginning inventory balance for each of the three preceding taxable years in issue.

The resulting product shall be the amount of the section 481(a) adjustment for each of the preceding taxable years, respectively. Any taxpayer electing to apply this procedure is required to use such procedure for each of the three taxable years in issue. The election to use this procedure may be made automatically by the taxpayer, without obtaining the consent of the Commissioner, by adopting such procedure in determining the timing of its section 481(a) adjustment under this section.

(ii) *Example illustrating procedure.*

Example. B, a calendar year taxpayer, is required to change its method of accounting for its taxable year beginning January 1, 1987. B's beginning inventory balance as of January 1, 1987, before the change in method of accounting, is $1,000. The revalued inventory balance after applying the change in method of accounting required by this section is $1,100 (a ten percent increase). B's beginning inventory balance as of January 1, 1986, was $900. Under this procedure, for applying the 75-percent rule, B may assume that the amount of the section 481(a) adjustment applicable to a change in method of accounting for the taxable year beginning January 1, 1986, would be $90 (ten percent multiplied by $900).

(5) *General examples.* The following examples illustrate the provisions of this paragraph.

Example (1). Y is required to change its method of accounting under this section for its taxable year beginning January 1, 1987. The adjustment required by section 481(a) to effect such change is $1,000. Y has been using its prior method of accounting for inventories for the 4-year period preceding the year of change. The highest percent of the section 481(a) adjustment attributable to either the 1-taxable year period, 2-taxable year period, or 3-taxable year period preceding the year of change is 67%. Based on the above facts, Y is required to include ratably the section 481(a) adjustment in taxable income for its four consecutive taxable years beginning with 1987, i.e., $250 of the section 481(a) adjustment should be included in taxable income for each of the four years.

Example (2). Assume the same facts as in example 1, except that the highest percent of the section 481(a) adjustment attributable to either the 1-taxable year period, 2-taxable year period, or 3-taxable year period, immediately preceding the year of change is 90%. Based on the above facts, Y is required to include 30% of the total section 481(a) adjustment into taxable income for each of its three consecutive taxable years beginning with 1987. The remaining 10 percent of the section 481(a) adjustment shall be included in income for the fourth taxable year, i.e., 1990.

Example (3). Assume that Y is required under this section to change its method of accounting for its taxable year beginning January 1, 1987. In addition, assume that in accordance with paragraph (e)(3)(iii), Y is required to include the section 481(a) adjustment in income over 4 years beginning with its 1987 taxable year. On December 31, 1987, the aggregate balance of Y's inventory to which the section 481(a) adjustment relates is reduced by more than 33⅓ percent of the aggregate balance at January 1, 1987. Further, the inventory is so reduced by at least such percentage on December 31, 1988. Y must include the remaining balance of the 481(a) adjustment in its income for December 31, 1988.

(6) *Revaluation of inventory*—(i) *In general.* Generally, in revaluing the costs of inventory under the change in method of accounting, taxpayers are required to make a determination, based on all of the facts and circumstances, of the direct and indirect costs which are to be assigned to each time of inventory under the capitalization rules of this section (the "facts and circumstances revaluation"). The facts and circumstances revaluation shall be required for every prior period which is relevant in determining the total restated balance as of the year of change. Paragraph (e)(6)(ii) of this section describes the facts and circumstances revaluation, including the degree of precision and accuracy which is necessary under that method. Paragraph (e)(6) (iii) and (iv) of this section permit the use of certain methods which determine the revaluation of inventory costs through processes of estimation and extrapolation which are not based on a determination of the facts and circumstances of a particular year's data. The methods prescribed in this paragraph (e)(6) (ii), (iii), and (iv) are available with respect to taxpayers producing property, or acquiring property for resale, regardless of whether those taxpayers elected to use the simplified methods available for such activities under this section.

(ii) *Facts and circumstances revaluation*—(A) *In general.* Under the facts and circumstances revaluation, taxpayers generally are required to revalue inventories by applying the capitalization rules of this section to the production and resale activities of the taxpayer, with the same degree of specificity as required of inventory manufacturers under the law immediately prior to the effective date of the Tax Reform Act of 1986. Thus, for example, with respect to any prior period which is relevant in determining the total amounts of the revalued balance as of the year of change, the taxpayer must analyze the production and resale data for that particular period, and apply the rules and principles of this section to determine the appropriate revalued inventory costs. However, under the facts and circumstances revaluation, taxpayers may utilize reasonable estimates and procedures in valuing inventory costs if:

(*1*) Taxpayers lack (and are not able to reconstruct, from their books and records), actual financial and accounting data which is required to apply the capitalization rules of this section to the relevant facts and circumstances surrounding a particular item of inventory or cost; and

(*2*) The total amounts of costs for which reasonable estimates and procedures are employed are not significant in comparison to the total restated value (including costs previously capitalized under the taxpayer's prior method of accounting) of the items or costs for the period in question.

Taxpayers who are not able to comply with the latter requirement of the preceding sentence because of the existence of a significant amount of costs which would require the use of estimates and procedures, shall revalue their inventories under the procedures provided in paragraph (e)(6) (iii) and (iv) of this section.

(B) *Estimates and procedures allowed.* The estimates and procedures of this paragraph (e)(6)(ii) include—

(*1*) The use of available information from more recent periods to estimate the amount and nature of inventory costs applicable to earlier periods; and

(*2*) The use of available information with resepct to comparable items of inventory produced or acquired during the same period in order to estimate the costs associated with other items of inventory.

(C) *Examples.* The provisions of this paragraph (e)(6)(ii) are illustrated by the following examples. The principles set forth in these examples are applicable both to production and resale activities.

Example (1). Taxpayer X lacks information for the years 1973 and earlier, regarding the amount of costs incurred in transporting finished goods from X's factory to X's warehouse and in storing those goods at the warehouse until their sale to customers. X determines that, for 1974 and subsequent years, such transportation and storage costs constitute 4 percent of the total costs of comparable goods under X's method of accounting for such years (the "section 471 costs"), before revaluation under this section. Under this paragraph (e)(6)(ii), X may assume that transportation and storage costs for the years 1973 and earlier constitute 4 percent of the total section 471 costs of such goods.

Example (2). Assume the same facts as in example (1), except that for the year 1973 and earlier, taxpayer X used a different method of accounting for inventory costs whereunder significantly fewer costs were capitalized under section 471 than amounts capitalized in later years. Thus, the application of transportation and storage based on a percentage of costs for 1974 and later years would not constitute a reasonable estimate for use in earlier years. X may use the information from 1974 and later years, if appropriate adjustments are made to reflect the differences in inventory costs for the applicable years, including, for example: (*i*) increasing the percentage of costs which are intended to represent transportation and storage costs to reflect the aggregate differences in capitalized amounts under the two methods of accounting; or (*ii*) taking the absolute dollar amount of transportation and storage costs for comparable goods in inventory and applying that amount (adjusted for changes in general price levels, where appropriate) to goods associated with 1973 and prior periods.

Example (3). Taxpayer Y lacks information for 1976 and earlier years regarding the amount of tax depreciation applicable to equipment used to manufacture inventories. For such years Y capitalized the amount of depreciation on such equipment equal to the depreciation which was treated as an inventoriable cost for "book" purposes, i.e., for purposes of financial reports. For years 1977 through 1980, Y determines that the requirement to capitalize the total amount of depreciation allowable for tax purposes under this section, results in additional capitalized depreciation equal to 5 percent of the total section 471 costs of the inventory property. Y may assume that the requirement to capitalize tax depreciation for the years 1976 and earlier constitutes as additional 5 percent of the total section 471 cost of such goods.

Example (4). Assume the same facts as in example (3), except that for 1976 and earlier years, taxpayer Y generally did not treat depreciation of equipment and facilities as an inventoriable cost for book purposes. Thus, for reasons similar to those set forth in example (2), Y may not use the revaluation percentages for tax depreciation in 1977 through 1980, in determining the amount of such depreciation for 1976 and earlier years. However, Y may use the available information for 1977 through 1980, if appropriate adjustments, similar to the adjustments prescribed in example (2), are made in determining the applicable amounts for 1976 and earlier years.

Example (5). Taxpayer Z lacks information for certain years with respect to factory administrative costs, subject to capitalization under this section, incurred in the production of inventory in factory A. Z does have sufficient information to determine factory administrative costs with respect to production of inventory in factory B, wherein inventory items were produced during the same years as factory A. Z may use the information from factory B to determine the appropriate amount of factory administrative costs to capitalize as inventory costs for comparable items produced in factory A during the same years.

(iii) *Weighted average method*—(A) *In general.* Taxpayers using the FIFO method of accounting or the specific goods LIFO method of accounting for inventories may use the weighted average method as provided in this paragraph (e)(6)(iii), to estimate the amount of additional costs that must be allocated to inventories for prior years. The weighted average method under paragraph (e)(6)(iii) is only available to taxpayers who lack sufficient data to revalue their inventory costs under the facts and circumstances revaluation method provided for in paragraph (e)(6) of this section. Moreover, taxpayers who qualify for the use of the weighted average method under this paragraph (e)(6)(iii) shall utilize such method only with respect to items or costs for which they lack sufficient information to revalue under the capitalization rules of this section. Particular items or costs must be revalued under the facts and circumstances revaluation method of this paragraph (e)(6)(ii), if sufficient information exists to make such a revaluation. If a taxpayer lacks sufficient information to otherwise apply the weighted average method under this paragraph (e)(6)(iii) (*e.g.*, the taxpayer is unable to revalue the costs of any of its items in inventory due to a lack of information), then the taxpayer shall use reasonable estimates and procedures, as described in the facts and circumstances revaluation method under paragraph (e)(6)(ii) of this section, to whatever extent is necessary to allow the taxpayer to apply the weighted average method.

(B) *Weighted average method for specific goods LIFO taxpayers.* (*1*) This paragraph (e)(6)(iii)(B) sets forth the mechanics of the weighted average method as applicable to LIFO taxpayers using the specific goods methods of valuing inventories. Under the weighted average method, the inventory layers with respect to an item for which data is available are revalued under this section and the increase in amount for each layer is expressed as a percentage of change from the cost in the layer as originally valued. A weighted average of the percentage of change for all layers for each type of good is computed and applied to all earlier layers for each type of good which lack sufficient data to allow for revaluation. In the case of earlier layers for which sufficient data exists, such layers are to be revalued using actual data. In cases where sufficient data is not available to make a weighted average estimate with respect to a particular item of inventory, a weighted average increase is to be determined using all other inventory items revalued by the taxpayer in the same pool; this percentage increase is then used to revalue the cost of the item for which data is lacking. If the taxpayer lacks sufficient data to revalue any of the inventory items contained in a pool, then the weighted average increase of "substantially similar" items (as determined by principles similar to the rules applicable to dollar-value LIFO taxpayer in § 1.472–8(b)(3)) shall be applied in the revaluation of the items in such pool. If insufficient data exists with respect to all the items in a pool and to all items which are substantially similar (or such items do not exist), then the weighted average for all revalued items in the taxpayer's inventory shall be applied in revaluing items for which data is lacking.

(*2*) *Example.*

Example. Taxpayer M, a manufacturer, produces two different parts. Work-in-process inventory is recorded in terms of equivalent units of finished goods. M's records show the following at the end of 1986 under the specific goods LIFO inventory method:

LIFO product and layer	Number	Cost	Carrying values
Product No. 1:			
1983	150	$5.00	$750
1984	100	6.00	600
1985	100	6.50	650
1986	50	7.00	350
Total			2,350
Product No. 2:			
1983	200	4.00	800
1984	200	4.50	900
1985	100	5.00	500
1986	100	6.00	600
Total			2,800

Note: Total carrying value of Product No. 1 and No. 2—5,150

M has sufficient data to revalue the unit costs of product #1 under the new capitalization rules of this section to $7.00 in 1984, $7.75 in 1985 and $9.00 in 1986. The available data for product #1 results in a weighted average percentage change for product #1 of 20.31 percent [(100 x ($7.00 − $6.00)) + (100 x ($7.75 − $6.50)) + (50 x ($9.00 − $7.00)) divided by (100 x $6.00) + (100 x $6.50) + (50 x $7.00)]. *M* has sufficient data to revalue the unit costs of product #2 to $6.00 on 1985 and $7.00 in 1986. The available data for product #2 results in a weighted average percentage change of 18.18 percent [(100 x ($6.00 − $5.00)) + (100 × ($7.00 − $6.00)) divided by (100 × $5.00) + (100 x $6.00)]. The revalued costs for product #1 for 1983 can be estimated by applying the weighted average increase determined for product #1 (20.31 percent) to the unit costs originally carried on the taxpayer's records for 1983. The estimated revalued unit cost in the case of product #1 would be $6.02 ($5.00 x 1.2031). The costs of product #2 are redetermined in a similar manner for 1983 and 1984 by applying the weighted average increase determined for product #2 of 18.18 percent to the unit costs of $4.00 and $4.50 for 1983 and 1984, yielding revalued unit costs of $4.73 and $5.32 respectively. M's inventory would be revalued as follows:

LIFO product and layer	Number	Cost	Carrying values
Product No. 1:			
1983	150	$6.02	$903
1984	100	7.00	700
1985	100	7.75	775
1986	50	9.00	450
Total			2,828
Product No. 2:			
1983	200	4.73	946
1984	200	5.32	1,064
1985	100	6.00	600
1986	100	7.00	700
Total			3,310

Notes:
Total of carrying value of Products No. 1 and No. 2 under section 263A—$6,138
Total amount of adjustment required under section 481(a)—$988

(C) *Weighted average method for FIFO taxpayers.* (*1*) This paragraph (e)(6)(iii)(C) sets forth the mechanics of the weighted average method as applicable to FIFO taxpayers. Under the weighted average method, an item in ending inventory for which sufficient data is not available for revaluation under this section shall be revalued by using the weighted average percentage increase with respect to such item for the first subsequent year for which sufficient data is available. With respect to an item for which no subsequent data exists, such item shall be revalued by using the weighted average percentage increase with respect to all reasonably comparable items in the taxpayer's inventory for the same year or the first subsequent year for which sufficient data is available.

(2) *Example.*

Example. Taxpayer A uses the FIFO method of valuing inventories. A maintains inventories of bolts, two types of which it no longer produces. Bolt A was last produced in 1984 and 1985. The revaluation of the costs of Bolt A under this section for bolts produced in 1984 results in a 20 percent increase of the costs of Bolt A. A portion of the inventory of bolt A, however, is attributable to 1983. A does not have sufficient data for revaluation of the 1983 layer for Bolt A. With respect to bolt A, A may apply the 20 percent increase determined for 1984 to the 1983 production as an acceptable estimate. Bolt B was last produced in 1982 and no data exists which would allow revaluation of the inventory cost of bolt B pursuant to the rules of this section. The inventories of all other bolts for which information is available are attributable to 1984 and 1985 production. Revaluation of the costs of these other bolts using available data results in an average increase in inventory costs of 15 percent for 1984 production. With respect to bolt B, the overall 15 percent increase for W's inventory for 1984 may be used in revaluing the cost of bolt B.

(iv) *3-year average method*—(A) *In general.* Taxpayers using the dollar-value LIFO method of accounting for inventories may revalue all existing LIFO layers of a trade or business based on the 3-year average method as provided in this paragraph (e)(6)(iv). The 3-year average method is based on the weighted average percentage change (the "3-year revaluation factor") in the current costs of inventory for each LIFO pool based on the three most recent taxable years for which the taxpayer has sufficient information (typically, the three most recent taxable years of such trade or business). The 3-year revaluation factor is applied to all layers for each pool in beginning inventory in the year of change. The 3-year average method is available to dollar-value taxpayers who comply with the requirements of this paragraph (e)(6)(iv) regardless of whether such taxpayers lack sufficient data to revalue their inventory costs under the facts and circumstances revaluation method prescribed in paragraphs (e)(6)(ii) of this section. The 3-year average method must be applied with respect to all inventory in a taxpayer's trade or business. Taxpayers are not permitted to apply the method for the revaluation of some, but not all, inventory costs on the basis of pools, business units, or other measures of inventory amounts which do not constitute a separate trade or business. Under the 3-year average method, for purposes of determining future indexes, the year prior to the year of change becomes a new base year, and all costs are restated in new base year costs for purposes of extending such costs in future years. However, costs associated with old layers retain their separate identity within the base year, with such layers being merely restated in terms of the new base year index. For example, for purposes of determining whether a particular layer has been invaded, each layer shall retain its separate identity; thus, if a decrement in an inventory pool occurs, layers accumulated in more recent years shall be viewed as invaded first, in order of priority. If a taxpayer lacks sufficient information to otherwise apply the 3-year average method under this paragraph (e)(6)(iv) (*e.g.,* the taxpayer is unable to revalue the costs of any of its LIFO pools for three years due to a lack of information), then the taxpayer shall use reasonable estimates and procedures, as described in the facts and circumstances revaluation method under paragraph (e)(6)(ii) of this section, to whatever extent is necessary to allow the taxpayer to apply the 3-year average method.

(B) *Consecutive year requirement.* Under the 3-year average method, if sufficient production data is available to calculate the revaluation factor for more than three years, the taxpayer may use data from such additional years in determining the average percentage increase only if the additional years are consecutive years prior to the year of change. The requirement under the preceding sentence to use consecutive years is applicable under this method regardless of whether any inventory costs in beginning inventory as of the year of change are viewed as incurred in, or attributable to, those consecutive years under the LIFO method. Thus, the requirement to use data from consecutive years may result in using information from a year in which no LIFO increment occurred. For example, if a taxpayer has sufficient data to revalue its inventory for the years 1981 through 1986, the taxpayer may calculate the revaluation factor using all six years. If, however, the taxpayer has sufficient data to revalue its inventory for the years 1980 through 1982, and 1984 through 1986, only the years consecutive to the year of change (*i.e.*, 1984 through 1986) may be used in determining the revaluation factor. Similarly, for example, a taxpayer with LIFO increments in 1985, 1983, and 1982 may not calculate the revaluation factor based on the data from those years alone, but instead must use the data from consecutive years for which the taxpayer has information.

(C) *Example.*

Example. *G*, a calendar year taxpayer, first adopted the dollar value LIFO method in 1981, using a single pool and the double extension method. *G's* beginning LIFO inventory for the year of change is as follows:

	Base year costs	Index	LIFO carrying value
Base layer	$14,000	1.00	$14,000
1981 layer	4,000	1.20	4,800
1982 layer	5,000	1.30	6,500
1983 layer	2,000	1.35	2,700
1984 layer	0	1.40	0
1985 layer	4,000	1.50	6,000
1986 layer	5,000	1.60	8,000
Total layer	34,000		42,000

G is able to recompute total inventoriable costs incurred under the rules of this section for the three preceding taxable years as follows:

Current year	Current cost as recorded (prior) law	Current cost as adjusted (263A)	Weighted percentage change
1984 layer	$35,000	$45,150	0.29
1985 layer	43,500	54,375	.25
1986 layer	54,400	70,720	.30
Total	132,900	170,245	.28

Applying the average revaluation factor of .28 to each layer, the inventory is restated as follows:

	Base year costs	Index	LIFO carrying value
Base layer	$17,920	1.00	$17,920
1981 layer	5,120	1.20	6,144
1982 layer	6,400	1.30	8,320
1983 layer	2,560	1.35	3,456
1984 layer	0	1.40	0
1985 layer	5,120	1.50	7,680
1986 layer	6,400	1.60	10,240
Total	43,520		53,760

The adjustment required by section 481(a) is the difference between (*i*) the revalued costs of the taxpayer's inventory under the new capitalization rules, and (*ii*) the costs of the taxpayer's inventory before the revaluation required under this section. Based on these facts, the adjustment required by section 481(a) would be equal to $11,760 ($53,760–$42,000). In addition, the year prior to the year of change in method of accounting shall be treated as a new base year for the purposes of determining the LIFO index in future years. This requires that layers in years prior to the base year be restated in terms of the new base year index. With respect to G, the restated inventory would be as follows:

	Restated base year costs	Index	LIFO carrying value
Old base layer	$28,672	0.625	$17,920
1981 layer	8,192	.75	6,144
1982 layer	10,272	.81	8,320
1983 layer	4,114	.84	3,456
1984 layer	0	.875	0
1985 layer	8,188	.938	7,680
New base layer (1986)	10,240	1.00	10,240
Total	69,678		53,760

(7) *Adjustments to inventory costs from prior years.* (i) *General rule.* (A) The use of the revaluation factor, based on current costs, to estimate the revaluation of prior inventory layers under the 3-year average method as described in paragraph (e)(6)(iv) of this section, may result in an allocation of costs that include amounts attributable to costs not incurred during the year in which the layer arose. To the extent that a taxpayer can demonstrate that costs which contributed to the determination of the revaluation factor could not have affected a prior year, the revaluation factor as applied to that year may be adjusted, under the restatement adjustment procedure, as described in paragraph (e)(9) of this section. Except as provided in paragraph (e)(7)(iii) of this section, the determination that a cost could not have affected a prior year shall be made by a taxpayer only upon showing that the type of cost incurred during the years used to calculate the revaluation factor (the "revaluation years"), was not present during such prior year. An item of cost will not be eligible for the restatement adjustment procedure simply by reason of the fact that the cost varies in amount from year to year or that the same type of cost is described or referred to by a different name from year to year. Thus, the restatement adjustment procedure allowed under paragraph (e)(9) of this section shall not be available in a prior year with respect to a particular cost if the same type of cost was incurred in both the revaluation years and in such prior year, although the amount of such cost (and the name or description thereof) may vary.

(B) The provisions of this paragraph (e)(7) shall also be applicable to taxpayers using the weighted average method in revaluing inventories under paragraph (e)(6)(iii) of this section. Thus, to the extent that a taxpayer can demonstrate that costs which contributed to the determination of the restatement of a particular year or item could not have affected a prior year or item, the taxpayer may adjust the revaluation of that prior year or item accordingly under the weighted average method. All the requirements and definitions, however, applicable to the restatement adjustment procedure under this paragraph (e)(7) shall fully apply to a taxpayer using the weighted average method to revalue inventories.

(ii) *Examples of costs eligible for restatement adjustment procedure.*

Example (1). Assume the taxpayer, A, introduced a defined benefit pension plan in 1984, and made the plan available to personnel whose labor costs were (directly or indirectly) properly allocable to production or resale activities. A determines the revaluation factor based on data available for the years 1984 through 1986, for which the pension plan was in existence. Based on these facts, the costs of the pension plan in the revaluation years are eligible for the restatement adjustment procedure for years prior to 1984.

Example (2). Assume the same facts as in example (1), except that a defined contribution plan was available, during prior years, to personnel whose labor costs were properly allocable to production or resale activities. The defined contribution plan was terminated before the introduction of the defined benefit plan in 1984. Based on these facts, the costs of the defined benefit pension plan in the revaluation years are not eligible for the restatement adjustment procedure with respect to years for which the defined contribution plan existed.

Example (3). Assume that the taxpayer, B established a service department in 1981, substantially all of the activities of which were devoted to administering the taxpayer's compliance with certain governmental regulations which were first issued and made effective for the year 1981. The governmental regulations issued in 1981 dealt with certain activities of the taxpayer which, under prior law, had not been regulated by any governmental body. B determines the revaluation factor based on data available for the years 1984 through 1986, for which the service department was in existence. Based on these facts, the costs of the service department in the revaluation years are eligible for the restatement adjustment procedure for 1980 and prior years.

Example (4). Assume that the taxpayer, C, established a security department in 1976, to patrol and safeguard the production and warehouse areas used in C's trade or business. Prior to 1976, C had not been required to utilize security personnel in its trade or business; C established the security department in 1976 in response to increasing vandalism and theft at its plant locations. Based on these facts, the costs of the security department are eligible for the restatement adjustment procedure for years prior to 1976.

Example (5). Assume that the taxpayer, D, established a payroll department in 1978 to process the company's weekly payroll. In the years 1974 through 1977, D engaged the services of an outside vendor to process the company's payroll. Prior to 1974, D's payroll processing department was done by D's accounting department, which was responsible for payroll processing as well as for other accounting functions. Based on these facts, the costs of the payroll department are not eligible for the restatement adjustment procedure. D was incurring the same type of costs in earlier years as D was incurring in the payroll department in 1978 and subsequent years, although these costs were designated by a different name or description.

Example (6). Assume that the taxpayer, E, established a legal department in 1976 to provide the company with legal services on a variety of matters. Prior to 1976, E engaged the services of outside counsel to obtain any necessary legal services. Based on these facts, the costs of the legal department are not eligible for the restatement adjustment procedure.

Example (7). Assume that the taxpayer, F, establishes a computer services department in 1977 in order to automate the processing and recordkeeping activities of the company. Prior to 1977, the processing and recordkeeping activities of the company had been performed by bookkeepers and other personnel in the company's accounting department. Based on these facts, the costs of the legal department are not eligible for the restatement adjustment procedure.

(iii) *Exception from general rule.* Costs which are described in this paragraph (e)(7)(iii) shall be eligible for the restatement adjustment procedure under paragraph (e)(9) of this section, even though such costs do not otherwise meet the requirements for such eligibility under the provisions of paragraph (e)(7)(i) of this section. Except as provided in this paragraph (e)(7)(iii), no other costs shall be eligible for the restatement adjustment procedure unless those costs satisfy the requirements of paragraph (e)(7)(i) of this section. Costs described in this paragraph which are eligible for the restatement adjustment procedure are costs attributable to different depreciation and cost recovery ("depreciation") methods used for federal income tax purposes, except that no adjustment shall be made for "applicable pre-cutoff years" as defined in paragraph (e)(8) of this section.

(iv) [Reserved.]

(v) *Example.*

Example. Assume that taxpayer, A, depreciated its equipment and facilities using the accelerated cost recovery system (ACRS) for the taxable years 1981 through 1986. A determines the revaluation factor based on data available for the years 1984 through 1986. With respect to taxable years prior to 1981, A used depreciation methods for federal income tax purposes which were less accelerated in nature than the ACRS system. Due to the requirement under this section that all tax depreciation (including the accelerated component thereof) incurred with respect to production equipment and facilities be capitalized, the use of the revaluation factor determined by reference to years 1984 through 1986 results in a higher revaluation factor than the factor which would be applicable for years prior to 1981 based on the facts and circumstances of those years. Although the differences in depreciation methods reflect only varying amounts of the same type of costs, such differences are eligible for the adjustment prescribed in paragraph (e)(9) of this section, subject to the requirements of this paragraph (e)(8) regarding any applicable pre-cutoff years.

(8) *Applicable pre-cutoff years.* A taxpayer may not adjust the revaluation factor by reason of the difference between depreciation methods used for federal income tax purposes, with respect to an applicable pre-cutoff year, as defined in this paragraph. A year will be considered as an applicable pre-cutoff year if (i) for such year, the taxpayer included in inventoriable costs under its method of accounting, less than 10 percent of "book" depreciation taken for that year with respect to the taxpayer's equipment and facilities used for production purposes; and (ii) with respect to the revaluation years, the taxpayer included in inventoriable costs under its method of accounting substantially all (i.e., at least 80 percent) of "book" depreciation taken for that year with respect to the taxpayer's equipment and facilities used for production purposes. Book depreciation, for this paragraph, shall mean the total depreciation taken for such year with respect to equipment and facilities for financial reporting purposes, regardless of whether such book depreciation was treated as an inventoriable cost for such financial reporting purposes. A year may be treated as an applicable pre-cutoff year under this paragraph (e)(8) if the taxpayer utilized either of the cut-off methods described in § 1.471-11(e)(3)(ii)(B) (*1*) or (*2*) (*i.e.*, cut-off methods available under the transition rules to the full absorption method of accounting) and the year otherwise qualifies as an applicable cut-off year under this paragraph. Similarly, a year may be treated as a pre-cut-off year under this paragraph, if the taxpayer changed its method of accounting for inventoriable costs and utilized a cut-off method to effectuate such change, regardless of whether the change in method of accounting was allowed under the Code, or was approved by the Commissioner. Although a particular year may be an applicable pre-cutoff year under this paragraph, the taxpayer will not be precluded from adjusting the revaluation factor with respect to differences between depreciation methods used for federal income tax purposes, for years subsequent to the applicable pre-cutoff year.

(9) *Restatement Adjustment Procedure.* (i) *In general.* (A) This paragraph (e)(9) provides a restatement adjustment procedure whereunder taxpayers may adjust the restatement of inventory costs in prior taxable years in order to produce a different restated value than the value that would otherwise occur through application of the revaluation factor to such prior taxable years.

(B) Under the restatement adjustment procedure as applied to a particular prior year, a taxpayer shall determine the particular items of cost which are eligible for the restatement adjustment with respect to such prior year. The taxpayer shall then recompute, by using reasonable estimates and procedures, the total inventoriable costs which would have been incurred for each revaluation year under—

(*1*) The taxpayer's previous method of accounting for inventories used during the revaluation year, and

(*2*) The capitalization rules of this section as applied to production activities in the revaluation year,

by making appropriate adjustments in the data for such revaluation year to reflect the particular costs eligible for adjustment.

(C) The taxpayer shall then compute the total percentage change with respect to each revaluation year, using the revised estimates of total inventoriable costs for such year as described in this paragraph (e)(9)(i)(B). The percentage change shall be determined by calculating the ratio of:

(*1*) The revised total of the inventoriable costs for such revaluation year under the capitalization rules of this section, to—

(*2*) The revised total of the inventoriable costs for such revaluation year under the prior method of accounting used for such year.

(D) A weighted average of the resulting percentage change for all revaluation years would then be calculated, and the resulting average would then be applied to the prior year in issue.

(ii) *Examples of restatement adjustment procedure*

Example (1). Assume that taxpayer A is eligible to make a restatement adjustment by reason of the costs of a defined benefit pension plan which was introduced in 1984, during the revaluation period. The revaluation factor, before adjustment of data to reflect the pension costs, is as provided in the example in paragraph (e)(6)(iv)(C) of this section. Thus, for example, with respect to the year 1984, the total inventoriable costs under prior law were $35,000 the total inventoriable costs under this section were $45,150, and the percentage restatement change for that year was .29. Under the prior method of accounting used by A during 1984, none of the pension costs were included as inventoriable costs. Thus, the total inventoriable cost under prior law would remain at $35,000 if the pension plan had not been in existence. Under the restatement adjustment procedure, A determines that the total inventoriable costs under this section for 1984, if the pension plan had not been in existence, would have been $42,000. The restatement adjustment for 1984 determined under this paragraph (e)(9) would then be equal to .20. A would make similar calculations with respect to 1985 and 1986. The weighted average of such amounts for each of the three years in the revaluation period would then be determined as in the example in paragraph (e)(6)(iv)(C) of this section. Such weighted average would be used to revalue cost layers for years for which the pension plan was not in existence. Such revalued layers would then be viewed as restated in compliance with the requirements of this paragraph. With respect to cost layers incurred during years for which the pension plan was in existence, no adjustment of the revaluation factor would occur, *i.e.*, the revaluation factor would be equal to .29.

Example (2). Assume the same facts as in example (1), except that a portion of the pension costs were included as inventoriable costs under the prior method of accounting used by A during 1984. Under the restatement adjustment procedure, A determines that the total inventoriable costs under the prior method of accounting for 1984, if the pension plan had not been in existence, would have been $34,000. Similarly, A determines that the total inventoriable costs under this section for 1984, if the pension plan had not been in existence, would have been $42,000. The restatement adjustment for 1984 determined under this paragraph (e)(9) would then be equal to .24. A would make similar calculations with respect to 1985 and 1986. The weighted average of such amounts for each of the three years in the revaluation period would then be determined as in the example in paragraph (e)(6)(iv)(C) of this section. Such weighted average would be used to revalue cost layers for years for which the pension plan was not in existence.

Example (3). Assume that taxpayer A is eligible to make a restatement adjustment by virtue of using ACRS depreciation during the revaluation period. With respect to certain taxable years before 1981, A used the asset depreciation range and class life system (ADR) of depreciation. The revaluation factor before adjustment of data to reflect the different depreciation methods is the same factor as provided in example (1), i.e., a percentage restatement change for 1984 of .29. Under the restatement adjustment procedure, A determines, using reasonable assumptions and estimates, the total amount of ADR depreciation which would have been allowable with respect to A's equipment and facilities in 1984, had the ADR system been in effect for such year (and for all relevant prior years), and had the ACRS system and deductions thereunder not been available. Assuming that only ADR depreciation had been used in 1984 for all of A's equipment and facilities, A determines the total inventoriable costs which would have been incurred under the capitalization rules of this section, *i.e.* rules which require the capitalization of all tax depreciation taken with respect to equipment and facilities. A determines that such amount is equal to $40,000. The restatement adjustment determined under this paragraph (e)(9) would then be equal to .14. The .14 restatement adjustment would be used to revalue costs layers for years for which only the ADR system had actually been used by A. With respect to cost layers incurred during years for which ACRS depreciation was actually taken by A, no adjustment of the revaluation factor would occur.

(10) *Anti-abuse rule*—(i) *In general.* Section 263A(h)(1) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 263A, including regulations to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of this section. One way in which the application of section 263A and this section would be otherwise avoided is through the use of entities described in the preceding sentence in such a manner as to effectively avoid the necessity to restate beginning inventory balances under the change in method of accounting required under this section.

(ii) *Deemed avoidance of this section*—(A) *Scope.* For purposes of this paragraph, the avoidance of the application of section 263A and this section will be deemed to occur if a taxpayer using the LIFO method of accounting for inventories, transfers inventory property to a related corporation in a transaction described in section 351, and such transfer occurs:

(*1*) On or before the beginning of the transferor's taxable year beginning in 1987; and

(*2*) After September 18, 1986.

(*B*) *General rule.* Any transaction described in paragraph (e)(10)(ii)(A) of this section shall be treated in the following manner:

(*1*) Notwithstanding any provision to the contrary (*e.g.*, section 381), the tranferee corporation shall be required to revalue the inventories acquired from the transferor under the provisions of this paragraph (e) relating to the change in method of accounting and the section 481(a) adjustment, as if the inventories had never been transferred and were still in the hands of the transferor; and

(*2*) Absent an election as described in paragraph (e)(10)(iii) of this section, the transferee shall account for the inventories acquired from the transferor by treating such inventories as if they were contained in the transferee's LIFO layer(s).

(iii) *Election to use transferor's LIFO layers.* If a transferee described in paragraph (e)(10)(ii) of this section so elects, the transferee shall account for the inventories acquired from the transferor by allocating such inventories to LIFO layers corresponding to the layers to which such properties were properly allocated by the transferor, prior to their transfer. The transferee shall account for such inventories for all subsequent periods with reference to such layers to which the LIFO costs were allocated. Any such election shall be made on a statement attached to the timely filed federal income of the transferee for the first taxable year for which this section applies to the transferee.

(iv) *Tax avoidance intent not required.* The provisions of paragraph (e)(10)(ii) of this section shall apply to any transaction described therein, without regard to whether such transaction was consummated with an intention to avoid federal income taxes.

(v) *Related corporation.* For purposes of this paragraph (e)(10), a taxpayer is related to a corporation if (A) the relationship between such persons is described in section 267(b)(1), or (B) such persons are engaged in trades or businesses under common control (within the meaning of paragraphs (a) and (b) of section 52).

(vi) *Cross reference.* See § 1.142–2T(h) regarding certain limitations on changes in taxable years that may apply, in some circumstances, to transactions described in this paragraph (e)(10).

(11) *Change in methods in accounting.* (i) *In general.* Taxpayers who are required to change their method of

accounting under this section may automatically change such method under the provisions of this paragraph (e)(11). The Commissioner may require such change in method of accounting under this paragraph (e)(11) to be made in accordance with such additional procedures as the Commissioner may prescribe, including the filing of an application to effect such change, at such time and in such a manner as the Commissioner may determine.

(ii) *Only certain changes allowed.* This paragraph shall only apply to changes in method of accounting required under this section. Taxpayers desiring to change their method of accounting, other than with respect to changes in method of accounting described in the preceding sentence, shall submit an application for change in accounting method under the administrative procedures applicable to such taxpayers at such time, including the applicable procedures regarding the time and place of filing the application for change in method of accounting.

(iii) *Definition of changes in method required.* For purposes of this paragraph (e)(11), a change in method of accounting is required under this paragraph (e)(11) if such change is necessary in order for the taxpayer to properly capitalize and allocate costs with respect to production and resale activities in the manner prescribed in this section. A change in method of accounting is not required under this paragraph (e) (11) if such change primarily relates to factors other than those described in the preceding sentence. For example, a required change in method of accounting does not include a change from one inventory valuation method to another inventory valuation method, such as—

(A) A change from LIFO (or FIFO) to FIFO (or LIFO);

(B) A change from an erroneous application of the lower of cost or market method to a correct method; or

(C) A change in accounting method for an inventory of securities from market value to cost.

In addition, a required change in method of accounting does not include a change within inventory valuation methods, such as a change from the "double-extension" method to the "link-chain method", or a change in the method used for determining the number of pools.

(iv) *Noncompliance with this provision.* Taxpayers who are required to change their method of accounting under this section and who fail to comply with the requirements of this paragraph (e)(11) shall be considered as using an improper method of accounting under the Code *Cf.*, section 446(f).

(f) *Cross reference.* See § 1.6001-1(a) regarding the duty of taxpayers to keep such records as are sufficient to establish the amount of gross income, deductions, etc.

Par. 3. Section 1.174-2 is amended by adding a sentence to the end of paragraph (a)(1) to read as follows:

§ 1.174-2 Definition of research and experimental expenditures.

(a) *In general.* * * *

(1) * * * See section 263A and the regulations thereunder for cost capitalization rules which apply to expenditures paid or incurred for research in connection with literary, historical or similar projects involving the production of property, including the production of films, sound recordings, video tapes, books, or similar properties.

* * * * *

Par. 4. Section 1.263(a)-1 is amended by adding a sentence to the end of paragraph (b) to read as follows:

§ 1.263(a)-1 Capital expenditures; in general.

* * * * *

(b) * * * Section 263A and the regulations thereunder for cost capitalization rules which apply to amounts referred to in paragraph (a) of this section with respect to the production of real and tangible personal property (as defined in § 1.263A-1T (a)(5)(iii)), including films, sound recordings, video tapes, books, or similar properties.

* * * * *

Par. 5. Section 1.263(a)-2 is amended by adding a sentence to the end of paragraph (b) to read as follows:

§ 1.263(a)-2 Examples of capital expenditures.

* * * * *

(b) * * * See section 263A and the regulations thereunder for capitalization rules which apply to amounts expended in securing and producing a copyright and plates in connection with the production of property, including films, sound recordings, video tapes, books, or similar properties.

* * * * *

Par. 6. Section 1.446-1 is amended by revising the last sentence in paragraph (a)(4)(i) to read as follows:

§ 1.446-1 General rule for methods of accounting.

(a) *General rule.* * * *

(4) * * *

(i) * * * (For rules relating to computation of inventories, see section 263A, 471, and 472 and the regulations thereunder.)

* * * * *

Par. 7. Section 1.471-3 is amended by revising the last sentence of paragraph (c) to read as follows:

§ 1.471-3 Inventories at cost.

* * * * *

(c) * * * See § 1.263A-1T for more specific rules regarding the treatment of production costs.

* * * * *

Par. 8. Section 1.471-5 is amended by adding a sentence to the end of such section to read as follows:

§ 1.471-5 Inventories by dealers in securities.

* * * See § 1.263A-1T for rules regarding the treatment of costs with respect to property acquired for resale.

Par. 9. Section 1.471-6 is amended by adding a sentence to the end of paragraph (f) to read as follows:

§ 1.471-6 Inventories of livestock raisers and other farmers.

* * * * *

(f) * * * See § 1.263A-1T for rules regarding the computation of costs for purposes of the unit livestock-price method.

* * * * *

Par. 10. Section 1.471-8 is amended by adding a sentence to the concluding text of paragraph (a) to read as follows:

§ 1.471-8 Inventories of retail merchants.

(a) * * *

* * * See § 1.263A-1T for rules regarding the computation of costs with respect to property acquired for resale.

* * * * *

Par. 11. Section 1.471-11 is amended by adding a sentence to the end of paragraph (a) to read as follows:

§ 1.471-11 Inventories of manufacturers.

(a) *Use of the full absorption method of inventory costing.* * * * See § 1.263A-1T with respect to the treatment of production costs with respect to taxable years beginning after December 31, 1986.

* * * * *

Par. 12. Section 1.1502-13 is amended by revising the last sentence of paragraph (c)(2) to read as follows:

§ 1.1502-13 Intercompany transactions.

* * * * *

(c) *Deferral of gain or loss on deferred intercompany transactions.* * * *

(2) *Determination of amount of deferred gain or loss.* * * * See

§ 1.263A–1T for costs properly includable in cost of goods sold.

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 13. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 14. Section 602.101(c) is amended by inserting in the appropriate places in the table "§ 1.263A–1T . . . 1545–0987", "§ 1.263A–1T . . . 1545–0987".

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impractical to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

Approved: March 20, 1987.

J. Roger Mantz,

Assistant Secretary of the Treasury.

[FR Doc. 87–6720 Filed 3–24–87; 3:17 pm]

BILLING CODE 4830-01-M

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26 CFR Part 5h

[T.D. 8124]

Certain Elections Under the Tax Reform Act of 1986; Corrections

AGENCY: Internal Revenue Service, Treasury.

ACTION: Corrections to temporary regulations.

SUMMARY: This document contains corrections to Treasury Decision 8124, which was published in the **Federal Register** for Thursday, February 5, 1987 (52 FR 3623). T.D. 8124 issued temporary regulations relating to the time and manner of making certain elections under the Tax Reform Act of 1986. The rules also provided guidance to persons making these elections.

FOR FURTHER INFORMATION CONTACT: Joel S. Rutstein, 202–566–3297 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The temporary regulations that are the subject of these corrections relate to certain elections under various sections of the Internal Revenue Code of 1986 and the Tax Reform Act of 1986 (the Act). These rules were added to the Temporary Regulations—Elections Under Various Public Laws (26 CFR Part 5h).

Need for Corrections

As published, Treasury Decision 8124 contains three typographical errors and one error of omission within the table under regulations § 5h.5. The three typographical errors fall under the heading "Availability of Election" on page 3625. The first error appears in printed line 20, the second error in printed line 39, and the third error in printed line 43.

The error of omission occurs under the heading "Section of Act" on page 3626 and appears in printed line 20.

Three additional typographical errors appear in the following locations: Page 3627, third column, first paragraph, line 20; page 3627, third column, third paragraph, line one; and page 3629, second column, fourth paragraph, line one.

Corrections of Publication

Accordingly, the publication of Treasury Decision 8124, which was the subject of FR Doc. 87–2219, is corrected as follows:

PART 5h—[CORRECTED]

§ 5h.5 [Corrected]

Paragraph 1. In the table, on page 3625, under the heading "Availability of Election", printed line 20, the upper-case letter "S" is removed from the word "Section" and the lower-case letter "s" is added in its place.

Par. 2. In the table, on page 3625, under the heading "Availability of Election", printed line 39, the misspelled word "occuring" is removed and the correct spelling of the word "occurring" is added in its place.

Par. 3. In the table, on page 3625, under the heading "Availability of Election", printed line 43, the word "the" is added immediately following the word "on".

Par. 4. In the table, on page 3626, under the heading "Section of Act", printed line 20, the letter "1" is added within the parenthesis immediately following the act section number "1810".

Par. 5. In § 5h.5, paragraph (a) (3) (iv), page 3627, third column, line 20, the word "paragraph" is removed and the word "paragraphs" is added in its place.

Par. 6. In § 5h.5, paragraph (a) (3) (vi), page 3627, third column, line one, the word "the" is added immediately following the word "making".

Par. 7. In § 5h.5, paragraph (e) (3), page 3629, second column, line one, the word "Partnership" is removed and the word "Partnerships" is added in its place.

Donald E. Osteen,

Director, Legislation and Regulations Division.

[FR Doc. 87–6927 Filed 3–27–87; 8:45 am]

BILLING CODE 4830-01-M

EQUAL EMPLOYMENT OPPORTUNITY COMMISSION

29 CFR Part 1613

Equal Employment Opportunity Commission in the Federal Government; Nomenclature Change

AGENCY: Equal Employment Opportunity Commission (EEOC).

ACTION: Final rule.

SUMMARY: The U.S. Equal Employment Opportunity Commission is changing the organizational title of its Complaints Examiner to Administrative Judges. The change is being made to reflect more accurately the nature of the position. The authority and duties of these positions remain the same as indicated in the current EEOC regulations.

EFFECTIVE DATE: March 30, 1987.

FOR FURTHER INFORMATION CONTACT: Nicholas M. Inzeo, Assistant Legal Counsel, or James M. Lager, Staff Attorney, at (202) 634–6690.

For the Commission.

Clarence Thomas,

Chairman.

PART 1613—[AMENDED]

1. The authority citation for Part 1613 continues to read as follows:

Authority: 5 U.S.C. secs. 1301, 3301, 3302, 7151–7154, 7301, E.O. 10577, 3 CFR, 1954–1958 Comp., p. 218; E.O. 11222, 3 CFR, 1964–1965 Comp., p. 306, E.O. 11478, 3 CFR, 1969 Comp., p. 133, unless otherwise noted.

§ 1613.218 [Amended]

2. Section 1613.218(a) is amended by removing the words "a complaints examiner" and inserting, in their place, the words "an Administrative Judge or complaints examiner," and by removing the words "complaints examiner" and inserting, in their place, the words "Administrative Judge."

§ 1613.220 [Amended]

3. Section 1613.220(c) is amended by removing the words "a complaints examiner" and inserting, in their place, the words "an Administrative Judge."