

INTERNAL REVENUE SERVICE  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM  
December 27, 2000

Number: **200121006**  
Release Date: 5/25/2001  
Index Nos.: 263A.01-02  
              471.01-00  
              162.04-09  
CASE No.: TAM-102392-00/CC:ITA:B7

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Year Involved:

Date of Conference:

LEGEND:

T =

a =

b =

ISSUE:

Whether property, such as stuffed animals, novelty toys and jewelry ("prizes"), which T offers to customers in its mechanical skill crane devices and treats as inventory when computing its combined absorption ratio under the simplified resale method, is subject to § 263A of the Internal Revenue Code.

CONCLUSION:

The property is subject to § 263A.

FACTS:

T owns and operates coin-operated, mechanical skill crane devices<sup>1</sup> (“devices”) that dispense a variety of prizes. A customer deposits coins into a device and maneuvers the device's crane in an attempt to retrieve the desired prize in the enclosed glass display. No customer is guaranteed a prize and an average customer spends a total of about \$a to obtain a prize that costs T approximately \$b. Prizes are purchased by T and either used in its own devices or resold to T's franchisees. Some of these prizes are manufactured especially to T's specifications, while others are purchased by T off the rack. T's devices are found in various locations, such as bars, bowling centers, supermarkets, and restaurants.

The prizes T sells to its franchisees are treated by T as “inventory” in its balance sheet for financial statement and income tax purposes. For income tax purposes, they are also treated as inventory when T computes a combined absorption ratio under the simplified resale method and when T allocates its additional § 263A costs to its ending inventory.

The prizes T uses to stock its own devices are also treated by T as inventory in its balance sheet for financial statement and income tax purposes. Moreover, for income tax purposes, they are also treated as inventory when T computes a combined absorption ratio under the simplified resale method. However, the prizes T uses to stock its own devices are NOT treated as inventory when T allocates its additional § 263A costs to its ending inventory. For this latter purpose, these prizes are treated as “supplies” that are used in its “service” business and not property held for sale that is subject to § 263A.

Treating prizes T uses to stock its own devices as inventory in T's computations under the simplified resale method produced a smaller absorption ratio and a lesser amount of additional § 263A costs, all of which was allocated to the prizes T treated as inventory for allocation purposes (i.e., only those it sells to its franchisees), than would have otherwise occurred. The examiner questions T's treatment of the prizes used in T's devices for purposes of § 263A.

#### LAW AND ANALYSIS:

Section 263A generally requires direct costs and an allocable portion of indirect costs of certain personal property acquired for resale by a taxpayer to be included in inventory costs, in the case of property that is inventory, or to be capitalized, in the case of other property.

Section 1.263A-3(d) of the Income Tax Regulations provides a simplified method for determining the additional § 263A costs properly allocable to property acquired for

---

<sup>1</sup> These devices are sometimes referred to as claws or diggers.

resale and other eligible property on hand at the end of the taxable year.

Section 471 provides that whenever, in the opinion of the Secretary, the use of inventories is necessary to clearly determine the income of the taxpayer, inventories must be taken by the taxpayer.

Section 1.471-1 generally requires a taxpayer to account for inventories when the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business.

Section 1.162-3 generally allows taxpayers carrying materials and supplies on hand to include in expenses the charges for the materials and supplies in the amount that they are actually consumed and used in operation during the tax year.

Under the facts presented, T treated the prizes that it uses to stock its own devices as "inventory" when calculating a combined absorption ratio under the simplified resale method. Since the treatment of these items as inventory for this purpose produced, as a direct consequence, the computation of a smaller absorption ratio and a lesser amount of additional § 263A costs than would have otherwise occurred (i.e., the amounts computed were smaller than if these items had not been treated as inventory for this purpose), consistency requires that T must likewise treat the prizes that it uses to stock its own devices as inventory when allocating additional § 263A costs to inventory.

T argues that the prizes that it uses to stock its own devices are "supplies", and as such, indirect costs are not allocable to these items under § 263A. The fact that T characterized these items as inventory in its balance sheet for financial statement and income tax purposes and when applying the simplified resale method should control their characterization for allocation purposes. However, we will examine T's argument that the prizes in question are not inventory, despite the inconsistency in T's position, to ensure that treatment as inventory is not improper under the Code or regulations. The conclusion reached is that, under T's specific circumstances, treatment of these items as inventory subject to § 263A is proper because they are significant, not incidental, in relation to the value of any service provided.

T asserts that it is providing a service<sup>2</sup> to customers and that the prizes provided in connection with the service are subordinate to the service. In support of this proposition, T argues that the prizes are subordinate based on the fact that an average customer is willing to spend about \$a in total to obtain a \$b prize (considering the fact that the average customer makes several attempts before eventually obtaining a prize).

---

<sup>2</sup> At this time, no question as been raised regarding T's classification of its activity as a "service".

Section 471 and the regulations thereunder require a taxpayer to use an inventory account whenever the production, purchase, or sale of merchandise is an income-producing factor. Section 263A identifies the costs that must be included in inventory. Presently, § 471 and its regulations do not define the term "merchandise". In the absence of a definition, courts have often identified items as merchandise without providing an underlying explanation for their determination. In *Wilkinson-Beane, Inc. v. Commissioner*, T.C. Memo. 1969-79, *aff'd*, 420 F.2d 352 (1st Cir. 1970), the court did explain its determination that caskets sold incident to funeral services were merchandise. By looking at financial accounting authorities and recognizing that merchandise and services could be simultaneously sold, the court decided that because the caskets were held for sale, the caskets were merchandise. Following *Wilkinson-Beane*, other courts have recognized that a taxpayer may sell both services and merchandise (see, e.g., *Thompson Electric, Inc. v. Commissioner*, T.C. Memo. 1995-292; *J.P. Sheahan and Assoc. v. Commissioner*, T.C. Memo. 1992-239) and that merchandise generally is goods held for sale.

From this judicial history, a basic understanding has emerged that "merchandise" is property that is transferred to a customer and that this transfer may occur in connection with services. Even assuming, for the sake of argument, that T is providing a service, under the particular facts presented here, T is also selling merchandise, the cost of which is significant in relation to any service provided. A prize is transferred to a customer after the customer pays some price for it and obtains it by successfully manipulating the crane. Once transferred, the customer has full ownership rights to the prize (a tangible item) and may keep, transfer, or do whatever desired with it. A sale has occurred, irrespective of the number of previous attempts to secure a prize.

Obviously, it is obtaining one of T's prizes that entices customers to insert coins into a device. The critical role that the prizes play is shown by T's placement of them in a glass case so that they can be clearly seen. Moreover, T has some prizes manufactured especially to its specifications, further showing their importance to T's business. Presumably, few, if any, customers would insert coins into a device, just to manipulate the crane, when the glass case is empty or if the device did not dispense prizes. Thus, we believe the prizes are a material income-producing factor in T's business, and in accordance with § 1.471-1 should be accounted for as inventory in order to clearly reflect T's taxable income.

T claims that the prizes used to stock its devices are not inventory but are supplies within the meaning of § 1.162-3. However, supplies are generally viewed as goods consumed during the production of property or the provision of services. See § 1.162-3. T's prizes are not consumed in the course of providing a service. More importantly, T is not furnishing prizes incidental to the provision of services, but is in the business of selling merchandise to customers in addition to possibly providing a "service". This merchandise, with a cost that is significant in relation to the value of

Page 5

any service provided, is subject to the requirements of § 263A.

CAVEAT:

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