INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-137496-03, CC:ITA:B06

District Director
Director of Field Operations

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year Involved:
Date of Conference:

LEGEND:

P =

S1 =

S2 =

D1 =

D2 =

D3 =

D4 =

Product 1 =

Product 2 =

Product 3 =

Product 4 =

Product 5 =

Product 6 =

Product 7 =

Product 8 =

ISSUES:

1. Whether for purposes of the Uniform Capitalization Rules under § 263A of the Internal Revenue Code (UNICAP), direct labor is an appropriate base to develop standard costs to allocate storage and handling costs to the taxpayer's inventory.

2. If direct labor is not an appropriate base to develop standard costs to allocate storage and handling costs to the taxpayer's inventory, what method may the Commissioner use to allocate the taxpayer's storage and handling costs?

CONCLUSIONS:

1. For purposes of § 263A, direct labor is not an appropriate base to use in developing standard costs to allocate storage and handling costs to the taxpayer's inventory.

2. Since direct labor is not an appropriate base to develop standard costs to allocate storage and handling costs to the taxpayer's inventory, the Commissioner may allocate the taxpayer's storage and handling costs using any method that in his opinion clearly reflects income.

FACTS:

P is a corporation engaged in the business of manufacturing Product 1, Product 2, Product 3, Product 4, Product 5, Product 6, Product 7, and Product 8 (collectively, Products). P consists of four divisions: D1, D2, D3, and D4. P does not maintain separate storage facilities devoted to the storage of raw materials. Instead, each division of P purchases raw materials and stores them at the plant where they will be manufactured into the final product. Thus, a portion of the cost of the manufacturing facility, including rent and depreciation, is allocable to the raw materials.

P, S1, and S2 file a consolidated federal income tax return. P is subject to the requirements of § 263A because it manufacturers Products. P determines its § 471 costs, as defined in § 1.263A-1(d)(2), remaining in ending inventory on a division-by-division basis. P determines its additional § 263A costs, as defined in § 1.263A-1(d)(3), remaining in ending inventory on an entity-level basis. In other words, P first determines its § 471 costs remaining in ending inventory for each of its divisions and then allocates additional § 263A costs to its total ending inventory.

All of P's divisions use a standard cost method to allocate § 471 costs to items in their ending inventories. In developing its standard costs, P uses direct labor as a base to allocate its § 471 overhead costs to ending inventory. At the end of the taxable year, P's ending inventory consists of unassigned raw materials, work-in–process (WIP), and finished goods.

For the taxable year at issue, P allocated storage and handling costs related to raw materials, WIP, and finished goods as a § 471 cost. Thus, in accordance with its standard cost method, P allocated storage and handling costs to its inventory using direct labor as a base. P's direct labor costs are allocable to its WIP and finished goods ending inventories, but are not allocable to its raw materials ending inventory. Since storage and handling costs are treated as § 471 overhead costs, storage and handling costs, along with other overhead costs, are only allocated to P's WIP and finished goods ending inventories, and not its raw materials ending inventory. P has asserted that it has allocated storage and handling costs in this manner for all the years of its existence, including years prior to the effective date of § 263A. For purposes of this request for technical advice, the Commissioner has assumed that P's assertion is correct. That is, the Commissioner will assume that P treated its storage and handling costs as indirect production costs for years prior to the effective date of § 263A.

P allocates any resulting variances from its use of its standard cost method using an inventory-turn method. S1 and S2 allocate § 471 overhead costs using an inventory-turn method. P, S1, and S2 use the simplified production method provided in § 1.263A-2(b) to allocate their additional § 263A costs.

The Examination Division contends that UNICAP requires taxpayers to capitalize the cost of storing and handling raw materials that are held for future production. The Examination Division further contends that UNICAP requires costs associated with storing and handling raw materials that are held for future production to be allocated to unassigned raw materials, that is, raw materials that have not yet entered the production process. Thus, the Examination Division argues that P's method of allocating storage and handling costs, which uses a standard cost method with direct labor as a base, does not clearly reflect income because it does not allocate costs to unassigned raw materials. In response, P concedes that UNICAP requires it to capitalize the cost of storing and handling raw materials that are held for future production. However, P argues that UNICAP does not require such costs to be allocated to unassigned raw materials.

LAW & ANALYSIS:

Section 263A generally requires a taxpayer to capitalize the direct costs and an allocable share of the indirect costs of the real or tangible personal property that it produces.

Section 263A(g) provides that the term “produce” includes construct, build, install manufacture, develop, or improve.

Section 1.263A-1(e)(2)(i) provides that producers must capitalize direct material costs and direct labor costs.

Section 1.263A-1(e)(3) provides that indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities.

Section 1.263A-1(e)(3)(ii)(G) provides that storage and handling costs are examples of costs that must be capitalized to the extent they are properly allocable to property produced or property acquired for resale.

Section 1.263A-1(f) sets forth various detailed or specific (facts-and-circumstances) cost allocation methods that taxpayers may use to allocate direct and indirect costs to property produced and property acquired for resale.

Section 1.263A-1(f)(2) provides that a specific identification method traces costs to a cost objective, such as a function, department, activity, or product, on the basis of a cause and effect or other reasonable relationship between the costs and the cost objective.

Section 1.263A-1(f)(3)(i) provides that a burden rate method allocates an appropriate amount of indirect costs to property produced or property acquired for resale during a taxable year using predetermined rates that approximate the actual amount of indirect costs incurred by the taxpayer during the taxable year.

Section 1.263A-1(f)(3)(ii) provides that a standard cost method allocates an appropriate amount of direct and indirect costs to property produced by the taxpayer through the use of preestablished standard allowances, without reference to costs actually incurred during the taxable year.

Section 1.263A-1(f)(4) provides that a taxpayer may use the methods described in paragraph (f)(2) or (3) of this section if they are reasonable allocation methods within the meaning of this paragraph (f)(4). In addition, a taxpayer may use any other reasonable method to properly allocate direct and indirect costs among units of property produced or property acquired for resale during the taxable year. An allocation method is reasonable if, with respect to the taxpayer's production or resale activities taken as a whole—

(i) The total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in this section or in §§1.263A-2 and 1.263A-3, with appropriate consideration given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, the time and cost of using various allocation methods, and the accuracy of the allocation method chosen as compared with other allocation methods;

(ii) The allocation method is applied consistently by the taxpayer; and

(iii) The allocation method is not used to circumvent the requirements of the simplified methods in this section or in §1.263A-2, § 1.263A-3, or the principles of § 263A.

Section 1.263A-2(a)(3)(ii) provides that if property is held for future production, taxpayers must capitalize direct and indirect costs allocable to such property (e.g., purchasing, storage, handling, and other costs), even though production has not begun. If property is not held for production, indirect costs incurred prior to the beginning of the production period must be allocated to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date. Thus, for example, a manufacturer must capitalize the costs of storing and handling raw materials before the raw materials are committed to production. In addition, a real estate developer must capitalize property taxes incurred with respect to property if, at the time the taxes are incurred, it is reasonably likely that the property will be subsequently developed.

Section 1.471-11(a) provides that in order to conform as nearly as may be possible to the best accounting practices and to clearly reflect income (as required by section 471 of the Code), both direct and indirect production costs must be taken into account in the computation of inventoriable costs in accordance with the “full absorption” method of inventory costing.

Section 1.471-11(d)(i) provides a taxpayer may use the so-called “standard cost” method of allocating inventoriable costs to the goods in ending inventory, provided he treats variances in accordance with the procedures prescribed in subdivision (ii) of this subparagraph. The method used by the taxpayer in allocating such costs in his financial reports shall be given great weight in determining whether the taxpayer's method employed for tax purposes fairly allocates indirect production costs to the ending inventory.

Issue 1. Whether for purposes of § 263A, direct labor is an appropriate base to develop standard costs to allocate storage and handling costs to the taxpayer's inventory.

For the following reasons, direct labor is not an appropriate base to develop standard costs to allocate storage and handling costs to the taxpayer's inventory:

1. P's use of direct labor as a base to allocate storage and handling does not allocate any storage and handling costs to unassigned raw materials. This is contrary to the specific requirements of § 1.263A-2(a)(3)(ii).

2. The capitalization of pre-production costs is supported by both the legislative history of UNICAP and case law. The legislative history of UNICAP provides that the costs of acquiring, producing, or carrying property should be capitalized and recovered when the property is sold in order to prevent a mismatching of expenses and related income and an unwarranted deferral of income.

3. The UNICAP regulations permit taxpayers to continue to use methods of allocation similar to those provided by the full absorption rules under § 1.471-11. A standard cost method is permitted under the full absorption rules and the UNICAP regulations. However, the UNICAP regulations clearly contemplate that a taxpayer may be required to change its standard cost method in order to comply with the requirements imposed by UNICAP.

4. P's standard cost method is not reasonable for purposes of § 1.263A-1(f)(4) because it does not allocate storage and handling costs to its inventory of unassigned raw materials that are stored and handled.

5. P's reliance on the fact that direct labor hours is a commonly used basis for allocating overhead costs under generally accepted accounting principles (GAAP) is misplaced.

Each of these reasons is discussed in more detail below.

1. Section 1.263A-2(a)(3)(ii) specifically provides that a taxpayer must allocate storage and handling costs to unassigned raw materials.

UNICAP generally requires a taxpayer to capitalize the direct costs and an allocable share of the indirect costs of the real or tangible personal property that it produces. See § 263A(a). A taxpayer "produces" property when it constructs, builds, installs, manufactures, develops, or improves property. See § 263A(g). The direct costs of property produced by a taxpayer include direct materials and direct labor costs. See § 1.263A-1(e)(2)(i). The indirect costs of produced property are all costs other than direct material costs and direct labor costs. Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities. See § 1.263A-1(e)(3). Storage and handling costs are examples of indirect costs that must be capitalized to the extent they are properly allocable to property produced or property acquired for resale. See § 1.263A-1(e)(3)(ii)(G) and (H).

Section 1.263A-1(f) provides various detailed or specific (facts-and-circumstances methods) cost allocation methods that taxpayers may use to allocate direct and indirect costs to produced property. A standard cost method is one of the facts-and-circumstances methods permitted by the regulations. See § 1.263A-1(f)(3)(i).

A standard cost method allocates an appropriate amount of direct and indirect costs to property produced through the use of pre-established standard allowances, without reference to costs actually incurred during the taxable year. See § 1.263A-1(f)(3)(ii)(A). Generally, standard allowances for overhead costs are developed using a ratio, percentage, or unit dollar amount obtained by dividing the costs being allocated by a base, such as a measure of activity or volume level. The regulations do not elaborate on the precise mechanics of the standard cost method. However, as discussed below, the preamble to the Treasury Decision that promulgated the UNICAP regulations reveals that the standard cost method was meant to follow the conceptual framework of standard costing employed by traditional cost accounting.

The preamble to Treasury Decision 8131, 1987-1 C.B. 98, which promulgated the temporary UNICAP regulations, indicates that the regulations permit the use of the standard cost method in accordance with the legislative history of the Tax Reform Act of 1986 (the Act), Pub. L. 99-514, 1986-3 (Vol. 1) C.B. 1. The legislative history of the Act indicates that Congress expected that the UNICAP regulations would permit allocations of costs among numerous items produced or held for resale by a taxpayer to be made on the basis of a burden rate method or other appropriate methods similar to those already provided under the law at the time. See S. Rep. No. 99-313, 142 (1986), 1986-3 (Vol. 3) C.B. 1, 142. In this regard, the committee report specifically cites § 1.471-11(d), which authorizes the use of the manufacturing burden rate method, the standard cost method, or any other method that fairly apportions such costs among items of inventory. See footnote 39 of S. Rep. 99-313, supra. When taxpayers use any of these methods, they are required to allocate additional § 263A costs to specific items in their inventory.[1]

Under § 1.471-11, manufacturers are required to use the "full absorption" method. Under the full absorption method, production costs are allocated to goods produced during the taxable year. Pursuant to § 1.471-11(d), indirect production costs required to be included in inventoriable costs must be allocated to goods in ending inventory using a method of allocation that fairly apportions such costs among the various items produced. These regulations provide that the standard cost method is an acceptable method for this purpose. See § 1.471-11(d)(3). Moreover, the regulations further provide that the standard cost method used by the taxpayer in allocating costs in financial reports shall be given great weight in determining whether the taxpayer's method employed for tax purposes fairly allocates indirect production costs to the ending inventory. See id.

In comparison to the full absorption method, which only required manufacturers to allocate manufacturing costs to items that are manufactured during the taxable year, UNICAP specifically requires producers to capitalize direct and indirect costs, except interest costs, properly allocable to produced property, without regard to whether those costs are incurred before, during, or after the production period. See § 1.263A-2(a)(3)(i). See also Reichel v. Commissioner, 112 T.C. 14 (1999); Von-Lusk v. Commissioner, 104 T.C. 207 (1995). Therefore, under UNICAP a taxpayer that is holding property for future production, must capitalize the direct and indirect costs allocable to such property (e.g., purchasing, storage, handling, and other costs), even though the taxpayer has not yet begun production. See § 1.263A-2(a)(3)(ii). The regulations further provide that if property is not held for production, indirect costs incurred prior to the beginning of the production period must be allocated to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date. See id. Thus, the regulations specifically require manufacturers to capitalize the costs of storing and handling raw materials before the raw materials are committed to production. See id.

P argues that the UNICAP regulations do not require the allocation of costs to unassigned raw materials. As is stated above, the UNICAP regulations provide that "[i]f property is held for future production, taxpayers must capitalize direct and indirect costs allocable to such property (e.g., purchasing, storing, handling, and other costs), even though production has not begun." § 1.263A-2(a)(3)(ii) (emphasis added). Moreover, the regulation section further provides that "[i]f property is not held for production, indirect costs incurred prior to the beginning of the production period must be allocated

[1] The simplified resale and the simplified production methods described in §§ 1.263A-2 and 1.263A-3 are exceptions to the general rule that costs required to be capitalized under § 263A must be allocated to specific items of inventory.

to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date." Id (emphasis added). P's unassigned raw materials are held for future production. Accordingly, P's argument ignores the requirements of § 1.263A-2(a)(3)(ii), which clearly provides that P is required to capitalize and allocate the storage and handling costs of unassigned raw materials to such property.

2. The capitalization of pre-production costs is supported by both the legislative history of UNICAP and case law.

The Tax Court has consistently held that § 1.263A-2(a)(3)(ii) is consistent with the legislative history of UNICAP. See Reichel v. Commissioner, supra; Von-Lusk v. Commissioner, supra. In fact, in Reichel the court specifically states that "[a] close analysis of the language and structure of § 263A supports the conclusion that Congress intended that the capitalization rules cover costs incurred before as well as during the production period." The tax court supported its statement by citing H.R. Rep. No. 99-426 (1985), 1986-3 C.B. (Vol. 2) 1, and S. Rep. No. 99-313, supra. These reports indicate that Congress was concerned that the full absorption rules were deficient because they allowed costs that are in reality costs of producing, acquiring, or carrying property to be deducted currently, rather than capitalized into the basis of property and recovered when the property is sold or as it is used by taxpayers. These reports further reveal that Congress believed that the capitalization rules prior to UNICAP produced a mismatching of expenses and the related income and an unwarranted deferral of income. See id. Congress enacted UNICAP to provide a single, comprehensive set of rules to govern the capitalization of costs of producing, acquiring, and holding property. See S. Rept. 99-313, supra at 140. The storage and handling costs that P incurs for its raw materials are the carrying costs of such property.

The legislative history also indicates that Congress generally patterned UNICAP after the extended period long-term contract rules. See S. Rep. No. 99-313, supra at 141. Under the extended period long-term contract rules, certain pre-production expenses, such as contract bidding costs, are required to be deferred until the contract is awarded. Subsequently, if the contract is awarded to the taxpayer, the costs are capitalized, and if the contract is not awarded to the taxpayer, the costs are deducted. See § 1.451-3(d)(6)(ii)(S).

In Reichel, the tax court also noted that the interest capitalization provisions of § 263A(f) provide that capitalization does not begin until the production period begins. The tax court observed that this provision would be superfluous if costs were not to be capitalized until the beginning of the production period.

3. The UNICAP regulations contemplate that a taxpayer may be required to change its standard cost method in order to comply with the new requirements imposed by UNICAP.

The legislative history of UNICAP and the UNICAP regulations provide that taxpayers are permitted to use allocation methods similar to those already provided under the full absorption rules provided by § 1.471-11, including the standard cost method. See S. Rep. No. 99-313, supra; § 1.263A-1(f)(3)(ii). However, neither the regulations nor the legislative history of UNICAP indicate that a specific taxpayer's method is insulated from modification. Instead, § 1.263A-1T(b)(3)(iii)(A)(3)(i) of the Temporary Income Tax Regulations provides that taxpayers may be required to change their existing allocation methods if they do not result in the allocation of sufficient amounts of indirect costs to production or resale activities. Moreover, articles by tax practitioners indicate that practitioners were aware that the changes made by UNICAP might require taxpayers to change their traditional cost accounting methods. See, e.g., Richard Garrett, James. E. Connor, & Annette B. Smith, Tax Management Portfolio, Uniform Capitalization Rules: Inventory; Self-Constructed Assets; Real Estate, No. 576, Modifying Existing Burden Rate to Comply with Section 263A, B.N.A., Worksheet 29 (1995). In fact, one such article indicates that UNICAP requires a taxpayer to modify its existing burden rates even if a taxpayer's method previously treated costs related to raw materials as § 471 costs. See id.

4. P's standard cost method is not reasonable for purposes of § 1.263A-1(f)(4) because it does not allocate storage and handling costs to its inventory of unassigned raw materials that are stored and handled.

Similar to § 1.471-11, the UNICAP regulations permit taxpayers to allocate § 263A costs using one of the facts-and-circumstances methods (a specific identification method, a burden rate method, or a standard cost method). See § 1.263A-1(f). The UNICAP regulations also permit taxpayers to allocate additional § 263A costs using certain simplified methods, the simplified production method and the simplified resale method. See §§ 1.263A-2(b) and 1.263A-3(d).[2] By their very nature, the simplified methods do not produce the same inventory value as the facts-and-circumstances methods. The simplified methods may capitalize more costs or less costs than a facts-and-circumstances method depending upon the taxpayer's particular facts and circumstances. In written comments to the proposed regulations concerning the

[2] Generally, a taxpayer's § 471 costs are the costs, other than interest, capitalized under the taxpayer's method of accounting immediately prior to the effective date of § 263A. See § 1.263A-1(d)(2). Whereas, a taxpayer's additional § 263A costs are generally defined as the costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of § 263A, but that are required to be capitalized under § 263A. See § 1.263A-1(d)(3).

simplified methods, some commentators expressed dissatisfaction with the simplified methods in cases where the methods capitalized more costs than a facts-and-circumstances method. Specifically,

> [a] number of commentators requested that the simplified production method in the temporary regulations be revised to reduce the amount of section 263A costs allocable to raw materials inventories. These commentators suggested that allocations based on this method may result in an excessive amount of the section 263A costs being allocated to raw materials inventories. They argue that this result occurs because the simplified production method does not take into account the fact that fewer indirect costs are incurred with respect to raw materials normally held only a short period of time than are incurred with respect to other items of inventory held longer. For example, a taxpayer that buys additional raw materials on the last day of the year would be required to allocate significantly more additional section 263A costs (such as storage, handling and carrying costs) to those materials under the simplified production method than it would under a facts and circumstances allocation method.
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> See Preamble to T.D. 8131, 1987-1 C.B. 98.

The final regulations did not adopt the commentators' recommendations. Instead, the preamble to the final regulations states, "[t]he Service and the Treasury believe that the simplified production method formula properly reflects the costs of raw materials that are purchased on the last day of the year. The taxpayer will have likely incurred purchasing costs and handling costs in obtaining these materials, which should be included in the inventoriable costs of these materials." See id. Accordingly, it clearly was contemplated that taxpayers using a facts-and-circumstances method would be required to capitalize storage and handling costs to unassigned raw materials.

Furthermore, under a specific identification method costs are traced to a cost objective, such as a function, department, activity, or product, on the basis of a cause and effect or other reasonable relationship between the costs and the cost objective. See § 1.263A-1(f)(2). In other words, the regulations require that the cost objective have some relationship to the allocated cost. Likewise, § 1.263A-1(f)(4) requires a taxpayer's burden rate or standard cost method to be a reasonable allocation method within the meaning of the regulations. For this purpose, § 1.263A-1(f)(4) provides that an allocation method is reasonable if, with respect to the taxpayer's production or resale activities taken as a whole –

> (i) The total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in the regulations, with

appropriate considerations given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, the time and cost of using various allocation methods, and the accuracy of the allocation method chosen as compared with other allocation methods.

(ii) The allocation method is applied consistently by the taxpayer; and

(iii) The allocation method is not used to circumvent the requirements of the simplified production method contained in § 1.263A-2 or the simplified resale method contained in § 1.263A-3 or the principles of § 263A.

For an allocation method to be accurate, the base chosen to allocate costs must have some causal relationship to the costs being allocated. In this case, P's method does not capitalize any storage and handling costs to its ending inventory of raw materials. P's ending inventory of raw materials necessarily has caused and is continuing to cause P to incur storage and handling costs. An accurate and reasonable allocation method must allocate costs to the items that give rise to the costs. Therefore, a method that allocates no costs to the items that gave rise to the costs is inaccurate, which in itself indicates that the base that P has chosen does not have any causal relationship to the costs being allocated.

In this case, P could have allocated its storage and handling costs using a standard cost method developed with an appropriate base (e.g., square footage or direct material costs). The use of a standard cost method developed with an appropriate base would have resulted in the allocation of storage and handling costs to WIP, finished goods, and also raw materials. Therefore, P's method is inaccurate as compared to another allocation method. Accordingly, P's standard cost method as related to its storage and handling costs is not reasonable for purposes of § 1.263A-1(f)(4).

5. P's reliance on the fact that direct labor is a commonly used base to allocate overhead costs for GAAP is misplaced.

P argues that its use of direct labor as a base to allocate all of its overhead costs, including storage and handling, is reasonable for purposes of GAAP and the full absorption provisions contained in § 1.471-11 and is, therefore, appropriate for purposes of UNICAP. P further argues that this result is required and contemplated by the legislative history of UNICAP. P also contends that its method already capitalizes the cost of storing and handling raw materials because such costs are considered by its present standard cost method. That is, P contends that its method capitalizes and allocates the cost of storing and handling raw materials to its work-in-process and finished goods inventories. To support its argument, P cites the preamble to the UNICAP regulations and the legislative history for the proposition that UNICAP only changed the type of costs required to be capitalized, but it did not require taxpayers to change their existing allocation methods.

P's argument oversimplifies the state of cost accounting prior to the adoption of UNICAP. Traditional cost accounting principles are far from simple and require detailed analysis of a company's product lines and manufacturing steps and processes.

Under traditional cost accounting principles, there are two primary methods used to assign overhead costs to production. Under the first method, actual manufacturing overhead costs are charged to actual goods produced. The other basic approach is a standard cost method. See Sidney Davidson & Roman L. Weil, Handbook of cost accounting10-13 to 10-18 (Prentice Hall 1978). Under a standard cost method, standard or predetermined rates are temporarily substituted for actual overhead costs. A standard or overhead rate is a ratio, percentage, or unit dollar amount obtained by dividing the manufacturing overhead costs for a segment of the firm's business by a measure of activity or volume level such as direct labor hours. See id. Other commonly used activity bases include direct labor dollars, machines hours, product units, direct material units or dollars. See id. A firm's predetermined or standard costs are based on overhead expense budgets and predetermined activity levels and are typically established by the cost accounting department in conjunction with budget and production planning departments. See id.

Generally, firms develop overhead rates on either a plant-wide or departmental basis. See id. Other acceptable alternatives are to develop product class rates or to apply separate rates for materials and labor. See id. The method chosen by any particular firm is contingent upon that firm's particular facts and circumstances. For example, a plant-wide rate is generally only applicable in a one-product, one-process plant. See id. On the other hand, a firm that manufactures some of its products and purchases others, for which little direct labor is incurred, may find it desirable to use two overhead rates, one based on labor and another based on materials. In this situation, if overhead costs were only applied to direct labor, the purchased items would be charged with little or no overhead costs even though they had to be purchased, received, inspected, handled, warehoused, and shipped. See id. Thus, traditional cost accounting requires a detailed analysis to determine the appropriate base to use to allocate costs and a one size fits all approach does not suffice. Instead, the determination of an appropriate base must be made in the context of a firm's particular facts and circumstances and the particular costs that are being allocated.

P's argument that its present method of accounting for storage and handling costs is reasonable because it considers all storage and handling costs when allocating overhead costs to work-in-process and finished goods inventories is misleading and does not lead to the conclusion that its method properly determines the cost of its unassigned raw materials. Instead, P's method merely determines the amount of cost allocable to the products it was designed to allocate costs to, i.e., work-in-process and finished goods.

Section 1.263A-2(a)(3)(ii) specifically provides that if property is held for future production, a taxpayer must capitalize the indirect costs allocable to such property. The regulation further elaborates that manufacturers must capitalize the costs of storing and handling raw materials before the raw materials are committed to production. For purposes of UNICAP, capitalize means to include in inventory costs if the costs are allocable to property included in inventory. See § 1.263A-1(c)(3). Inventories include raw materials that physically become part of merchandise intended for sale. See § 1.471-1. Moreover, as previously stated, the regulations require taxpayers using a facts-and-circumstances method, including a standard cost method, to allocate costs to specific items in inventory. In this case, P's method does not determine the indirect costs allocable to unassigned raw materials in its inventory. Accordingly, P's use of direct labor as a base to allocate storage and handling costs is improper.

Lastly, P implies that conformance with GAAP is all that is required with regard to a taxpayer's allocation method. At first glance, this argument seems to find support in § 1.471-11(d), which provides that the standard cost method used by a taxpayer in allocating costs in financial reports will be given great weight in determining whether the taxpayer's method employed for tax purposes fairly allocates indirect production costs to ending inventory. However, the general presumption provided by this section must yield to any inconsistency provided by the UNICAP regulations. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 540 (1979). As explained above, the results obtained by P's allocation method is inconsistent with the UNICAP regulations. Moreover, in Thor Power, the Supreme Court specifically recognized the vastly different objectives of financial and tax accounting. In that case, the Supreme Court noted that "generally accepted accounting principles … tolerate a range of reasonable treatments leaving the choice among alternatives to management …[and if management's choice] were dispositive for tax purposes, a firm could decide unilaterally – within limits dictated only by its accountants – the tax it wished to pay." See Thor Power Tool Co. v. Commissioner, supra at 544. Likewise, P's decision to use direct labor as a base to allocate storage and handling costs is not dispositive. Instead, the allocation method used must be judged in light of the capitalization requirements provided by UNICAP.

Since P's present method of allocating overhead cost fails to allocate any amount of overhead costs to its unassigned raw materials inventory, we conclude that P's use of direct labor as a base to allocate storage and handling costs is improper.

Issue 2. If direct labor is not an appropriate base to develop a standard cost to allocate storage and handling costs to the taxpayer's inventory, what method may the Commissioner use to allocate the taxpayer's storage and handling costs?

Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method, as in the opinion of the Secretary , does clearly reflects income. The Commissioner's authority under § 446(b) permits him to select the method of accounting a taxpayer must use once he has determined that a taxpayer's method does not clearly reflect income. See Thor Power Tool Co. v. Commissioner, supra. Since we have determined that P's method for allocating storage and handling cost is inappropriate, the Commissioner may compute P's taxable income using any method for allocating storage and handling costs that in his opinion clearly reflects income.

CAVEAT:

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