Internal Revenue Service

Department of the Treasury
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Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:B06
PLR-100399-08

Date:
April 14, 2008

Legend
Taxpayer =
Date 1 =
Date 2 =
Product
S =
Date 3 =

Dear :

Taxpayer is requesting a ruling under § 1.381(c)(5)-1(d) of the Income Tax Regulations to receive the Commissioner's consent to change to a method other than the principal method of accounting. Specifically, Taxpayer is requesting consent to change its method of accounting for and allocating costs under § 263A of the Internal Revenue Code and the regulations thereunder, for the taxable year beginning Date 1 and ending Date 2.

The facts submitted indicate that Taxpayer filed a consolidated return with S, its wholly-owned subsidiary, for the taxable year ending Date 3. Taxpayer was under examination on the date the private letter ruling request was filed. Taxpayer submitted a statement certifying that, to the best of Taxpayer's knowledge, the same method of accounting is not an issue under consideration or an issue placed in suspense by the examining agent(s).

Taxpayer manufactures Product. Taxpayer accounts for its inventory under the first-in, first-out (FIFO) method valued at cost or market, whichever is lower. Taxpayer

allocates its direct material costs, direct labor costs, and indirect costs fully allocable to production activities to property produced using the standard cost method. Taxpayer states that it does not capitalize certain indirect costs required to be capitalized under § 263A. These costs include royalties and book/tax differences related to inventoriable costs. Taxpayer uses reasonable factors and relationships to determine capitalizable mixed service costs. Taxpayer allocates additional § 263A costs to ending inventory based on a direct labor turnover ratio. S does not allocate any additional § 263A costs to ending inventory.

Taxpayer liquidated S on Date 3 in a transaction qualifying as a tax-free liquidation under § 332, subject to § 381 and the regulations thereunder. The businesses of Taxpayer and S were not operated as separate trades or businesses under § 446(d) and § 1.446-1(d) immediately after the transactions insofar as Taxpayer combined the separable books and records into a single trial balance.

Taxpayer is requesting a private letter ruling because of § 1.381(c)(5)-1(d)(1)(i). This regulation provides, in relevant part, that if an acquiring corporation is not permitted to continue the use of the method of taking inventories used by it or the distributor or transferor corporation or corporations on the date of distribution or transfer, and is not permitted, under § 1.381(c)(5)-1(c), to use the principal method of taking inventories, then such acquiring corporation must request the Commissioner to determine the appropriate method of taking inventories.

Taxpayer determined that its method of accounting for and allocating costs under § 263A is the principal method under § 1.381(c)(5)-1(c)(2). Taxpayer states that the principal method of accounting for and allocating costs under § 263A is an impermissible method under § 263A and the regulations thereunder. Accordingly, Taxpayer must request a private letter ruling under § 1.381(c)(5)-1(d)(2) to use a method other than the principal method.

Section 1.236A-1(g)(4)(i) provides, in relevant part, that, using reasonable factors or relationships, a taxpayer must allocate mixed service costs using a direct reallocation method, a step-allocation method, or any other reasonable allocation method (as defined under the principles of § 1.263A-1(f)(4)).

Section 1.263A-1(f)(4) provides, in relevant part, that an allocation method is reasonable if, with respect to the taxpayer's production 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 §1.263A-1(f), with appropriate consideration given to the volume and value of the taxpayer's production 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 §§ 1.263A-1, 1.263A-2, 1.263A-3, or the principles of § 263A.

Section 1.263A-2(b) provides the formula for allocating additional § 263A costs to eligible property remaining on hand at the close of the taxable year under the simplified production method.

Under its proposed method, Taxpayer will determine capitalizable mixed service costs using a reasonable allocation method. *See* § 1.263A-1(g)(4)(i). Under this method, Taxpayer will allocate its service costs to particular activities based on a factor or relationship that reasonably relates the service cost to the benefits received from the service activity. Taxpayer will determine the capitalizable portion of the cost of most of its mixed service departments based on the proportion of time employees in the department spend performing the service activity in support of production. Taxpayer will determine an initial capitalization factor for each department in the year of change and will update the factor at regular intervals.

Taxpayer will use the simplified production method without the historic absorption ratio election to allocate its additional § 263A costs to ending inventory. *See* § 1.263A-2(b)(3). The § 471 costs under the simplified production method will include direct material, direct labor, and indirect costs fully allocable to production activities, other than interest. The additional § 263A costs under the simplified production method will include mixed service costs allocable to production activities, royalties, and book/tax differences relating to inventoriable costs.

Pursuant to § 1.381(c)(5)-1(e)(4), Taxpayer will compute the adjustments necessary to reflect Taxpayer and S's change to the proposed § 263A method in the same manner as if on the date of the liquidation Taxpayer and S initiated a change to the proposed § 263A method and will take the adjustments into account in computing taxable income in the taxable year that includes the transaction.

Accordingly, the Commissioner under § 1.381(c)(5)-1(d) grants consent to Taxpayer to use a method other than the principal method of accounting as determined under § 1.381(c)(5)-1(c) and allows Taxpayer to change its method of accounting to its proposed method.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Taxpayer's use of a reasonable allocation method for determining its capitalizable mixed service costs is based on the assumption that the total costs actually capitalized during the taxable year under the proposed method will not differ significantly from the aggregate costs that would properly be capitalized using the methods of accounting for mixed service costs described in the regulations. *See* § 1.263A-1(g)(4)(i). We express no opinion regarding the propriety of Taxpayer's

method of allocating mixed service costs between production and non-production activities using a reasonable allocation method under § 1.263A-1(g)(4)(i). These determinations are to be made by the operating division director in connection with the examination of Taxpayer's federal income tax returns.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. One item on the 2007-2008 Priority Guidance Plan is guidance under § 263A regarding the treatment of “negative” additional § 263A costs under § 1.263A-1(d)(4). Therefore, should guidance be issued that is inconsistent with the conclusions reached in this private letter ruling, the method of accounting utilized as a result of this private letter ruling will be subject to change within the framework of §§ 446 and 481.

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

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

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

Sincerely,

Roy A. Hirschhorn
Senior Technician Reviewer, Branch 6
(Income Tax & Accounting)

cc: