

# Notice of Proposed Rulemaking and Notice of Public Hearing

## Special Rules Regarding the Simplified Production and Resale Methods With Historic Absorption Ratio Election

**REG-113910-98**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

**SUMMARY:** This document contains proposed regulations under section 263A that relate to accounting for costs incurred in producing property and acquiring property for resale. The proposed regulations are necessary to address specific problems in the current section 263A regulations and affect persons who elect to use the simplified production or resale meth-

ods with historic absorption ratio election. This document also provides notice of a public hearing on these proposed regulations.

**DATES:** Written and electronic comments must be received by August 23, 1999. Outlines of topics to be discussed at the public hearing scheduled for September 1, 1999, at 10 a.m., must be received by August 11, 1999.

**ADDRESSES:** Send submissions to: CC:DOM:CORP:R (REG-113910-98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-113910-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at [http://www.irs.ustreas.gov/tax\\_regs/regslst.html](http://www.irs.ustreas.gov/tax_regs/regslst.html). The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Concerning the regulations, Jennifer Nuding, (202)622-4970; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke at (202) 622-7180 (not toll-free calls).

#### SUPPLEMENTARY INFORMATION:

##### *Background*

Section 263A provides uniform rules for capitalization of certain expenses. Section 263A requires the capitalization of the direct, and an allocable portion of the indirect, costs of real or tangible personal property produced by a taxpayer or real and personal property described in section 1221(1) that is acquired by the taxpayer for resale. The rules under section 263A, which were added by the Tax Reform Act of 1986, Public Law 99-514, section 803, 100 Stat. 2085, 2350, were designed, in part, to properly match in-

come with related expenses and, thus, more accurately reflect income. They also were intended to make the tax system more neutral by eliminating the differences in capitalization rules that created distortions in the allocation of economic resources and the manner in which certain economic activity was organized. See S. Rep. No. 313, 99th Cong., 2d Sess. 140 (1986), 1986-3 C.B. Vol. 3 140. However, the legislative history provides authority to the Secretary to prescribe simplifying methods and assumptions where the costs and other burdens of literal compliance with section 263A may outweigh the benefits of the provision (e.g., matching and neutrality). S. Rep. No. 313, 99th Cong., 2d Sess. 142 (1986).

Section 263A costs are the costs that a taxpayer must capitalize under section 263A and equal the sum of a taxpayer's section 471 costs, its additional section 263A costs, and interest capitalizable under section 263A(f). Additional section 263A costs are the costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of section 263A, but that are required to be capitalized under section 263A.

Sections 1.263A-1 through 1.263A-3 of the final regulations (T.D. 8482, 1993-2 C.B. 77) were published in the **Federal Register** for August 9, 1993 (58 F.R. 42207) and amended by T.D. 8559 (59 F.R. 39958), T.D. 8584 (59 F.R. 67187), T.D. 8597 (60 F.R. 36671), T.D. 8728 (62 F.R. 42051) and T.D. 8729 (62 F.R. 44542). The final regulations provide simplified methods for determining the additional section 263A costs properly allocable to eligible property on hand at the end of the taxable year, including ending inventories of property produced and property acquired for resale. The final regulations include the simplified production method contained in the temporary regulations issued under 263A, §1.263A-1T(b)(5), T.D. 8131 (58 F.R. 151), and the simplified resale method, a redesignation of the modified resale method set forth in Notice 89-67, 1989-1 C.B. 723. A taxpayer using either the simplified production method or the simplified resale method determines the additional section 263A costs properly allocable to eligible property on hand at the end

of the taxable year by multiplying its absorption ratio by the section 471 costs on hand at year-end. Under both the simplified production method and the simplified resale method, an absorption ratio is calculated annually and applied to determine the additional section 263A costs allocated to ending inventory.

In response to requests for additional simplification, the final regulations provide an election to use an historic absorption ratio to determine additional section 263A costs allocable to eligible property on hand at year-end that may be used in connection with either the simplified production method or the simplified resale method.

The final regulations permit a taxpayer that properly elects to use the historic absorption ratio to determine the additional section 263A costs allocable to eligible property on hand at the end of the taxable year by using an historic absorption ratio in lieu of an actual absorption ratio, i.e., by multiplying the historic absorption ratio by section 471 costs on hand at year-end. The historic absorption ratio is based on costs capitalized by a taxpayer during its test period, generally the three taxable-year period immediately prior to the taxable year that the taxpayer elects the historic absorption ratio. The historic absorption ratio equals the taxpayer's additional section 263A costs incurred during the test period divided by the section 471 costs incurred by the taxpayer during the test period. Under the final regulations, taxpayers are required to test the accuracy of the historic absorption ratio every six years. If the test of the ratio indicates more than one-half of one percentage point difference (plus or minus) from the historic absorption ratio, the taxpayer must redetermine its historic absorption ratio using a new updated test period. The final regulations provide that, if elected, the historic absorption ratio must be used for each taxable year within the qualifying period. Generally, the qualifying period includes each of the first five taxable years beginning with the first taxable year after a test period (or an updated test period).

##### *Explanation of Provisions*

This document contains proposed amendments to the Income Tax Regula-

tions (26 CFR part 1) that relate to the capitalization of certain costs under section 263A. More specifically, this document contains proposed amendments with respect to the historic absorption ratio election that are necessary to carry out the purpose of section 263A. The rules under section 263A were designed to properly match income with related expenses by requiring all of the costs relating to an item produced or acquired for resale to be included in the basis or inventoriable cost of that item. The simplified production method and the simplified resale method were included in the regulations to provide taxpayers with a simplified method for determining the additional section 263A costs allocable to items on hand at year end. The historic absorption ratio election was provided in response to commentators' concerns that computations under the simplified production method and the simplified resale method are costly and time consuming because taxpayers must determine absorption ratios annually, even though there may have been little or no change in the taxpayers' business operations that would cause the absorption ratios to vary from year to year.

The historic absorption ratio election in the final regulations is intended to permit taxpayers to determine additional section 263A costs allocable to items on hand at year-end without calculating actual absorption ratios while still capitalizing the costs properly allocable to property produced or acquired for resale. The historic absorption ratio was selected in lieu of an industry-based ratio because the IRS and Treasury Department believed that a ratio based on taxpayer specific historical data would more reasonably approximate the taxpayer's annual absorption ratio than an industry-based ratio.

The IRS and Treasury Department have become aware that the historic absorption ratio may become materially inaccurate generally as the result of a significant change in a taxpayer's circumstances during the qualifying period, thus resulting in a failure to allocate the proper amount of additional section 263A costs to items on hand at year-end. Although the regulations provide that a taxpayer must test its historic absorption ratio every six years, a significant deviation from the taxpayer's

actual absorption ratio could result in a substantial mismatching of the taxpayer's income and related expenses during the qualifying period.

The IRS and Treasury Department considered many alternate approaches to revising the historic absorption ratio regulations in order to prevent a substantial mismatching of income and related expenses. Among the approaches considered and rejected were the following: (1) eliminate the historic absorption ratio election entirely; (2) limit use of the historic absorption ratio election to small taxpayers; (3) require taxpayers to retest their historic absorption ratio more frequently, e.g., every three years; and (4) provide a general anti-abuse rule.

These proposed regulations provide for early termination of the qualifying period if the taxpayer's historic absorption ratio is materially inaccurate. In such a case, the taxpayer must calculate a new historic absorption ratio beginning with the year in which the taxpayer's historic absorption ratio became materially inaccurate.

Generally, a taxpayer's historic absorption ratio may become materially inaccurate when the taxpayer experiences a significant change in the taxpayer's normal business operations and that change has an effect on the taxpayer's section 263A absorption ratio. For example, the following changes may cause a taxpayer's historic absorption ratio to become materially inaccurate: a significant change in the taxpayer's manufacturing process, e.g. implementation of a new inventory management system; a significant change in the taxpayer's product offering; a significant addition or retirement of equipment used for manufacturing; a significant change in the taxpayer's components of cost, e.g., a manufacturing operation that becomes significantly more or less labor intensive; a significant change in the taxpayer's overhead costs, e.g. a new plant, building or building addition; and a significant change in the taxpayer's trade or business, e.g., the sale or acquisition of a division.

The proposed regulations establish a high threshold for when the historic absorption ratio will be regarded as materially inaccurate. The regulations provide a definition of materially inaccurate that incorporates both a percentage test and a

specific dollar amount test. The regulations provide that the historic absorption ratio is materially inaccurate if: (1) the taxpayer's actual absorption ratio deviates by more than 50% and by more than one-half of one percentage point from the taxpayer's historic absorption ratio; and (2) the amount of additional section 263A costs capitalizable to items on hand at year-end using the actual absorption ratio deviates by more than \$100,000 from the amount of additional section 263A costs capitalizable to items on hand at year-end using the historic absorption ratio. This high threshold is provided so that annual actual absorption ratio computations will be unnecessary in the overwhelming majority of situations. For example, the placement in service of a significant amount of property may have a significant effect on a taxpayer's actual absorption ratio. However, it may not be necessary for a taxpayer to compute its actual absorption ratio for a year that the taxpayer placed property in service if, based on the taxpayer's knowledge of the difference between its tax depreciation and book depreciation, and its inventory turnover, the taxpayer knows that it would be impossible for the amount of additional section 263A costs allocable to items on hand at year-end to increase by \$100,000 if the taxpayer used the simplified production method without the historic absorption ratio election. Therefore, the taxpayer would not need to calculate an actual absorption ratio for that year.

#### *Proposed Effective Date*

The provisions of these regulations are proposed to be effective for taxable years beginning after May 24, 1999.

#### *Special Analyses*

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal

Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) and electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, September 1, 1999, in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written or electronic comments by August 23, 1999 and submit an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by August 11, 1999.

A period of 10 minutes will be allocated to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### Drafting Information

The principal author of these regulations is Jennifer Nuding of the Office of

Assistant Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### Part 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Par. 2. Section 1.263A-2 is amended as follows:

1. Paragraphs (b)(4)(ii)(C)(1) and (2) are revised;

2. New paragraphs (b)(4)(ii)(C)(3) and (4) are added;

3. Paragraph (b)(4)(vi) is amended by:

- Revising the paragraph heading and introductory text;

- Redesignating the *Example* as *Example 1*;

- Adding new *Example 2* and *Example 3*.

The revisions and additions read as follows:

#### *§1.263A-2 Rules relating to property produced by the taxpayer.*

\* \* \* \* \*

(b) \* \* \*

(4) \* \* \*

(ii) \* \* \*

(C) *Qualifying period*—(1) *In general.*

A qualifying period generally includes each of the first five taxable years beginning with the first taxable year after a test period (or an updated test period). However, a qualifying period may be extended under the provisions of paragraph (b)(4)(ii)(C)(2) of this section or may terminate early under the provisions of paragraph (b)(4)(ii)(C)(3) of this section.

(2) *Extension of qualifying period.* In the first taxable year following the close of each qualifying period, (e.g., the sixth taxable year following the test period), the taxpayer must compute the actual absorption ratio under the simplified production method. If the actual absorption ratio computed for this taxable year (the recomputation year) is within one-half of one percentage point (plus or minus) of

the historic absorption ratio used in determining capitalizable costs for the qualifying period (e.g., the previous five taxable years), the qualifying period is extended to include the recomputation year and the following five taxable years (or a shorter period if the qualifying period is terminated early under the provisions of paragraph (b)(4)(ii)(C)(3) of this section), and the taxpayer must continue to use the historic absorption ratio throughout the extended qualifying period. If, however, the actual absorption ratio computed for the recomputation year is not within one-half of one percentage point (plus or minus) of the historic absorption ratio, the taxpayer must use actual absorption ratios beginning with the recomputation year under the simplified production method and throughout the updated test period. The taxpayer must resume using the historic absorption ratio (determined with reference to the updated test period) in the third taxable year following the recomputation year.

(3) *Earlier termination of the qualifying period.* For taxable years beginning after May 24, 1999, a qualifying period closes immediately prior to a taxable year in which the taxpayer's historic absorption ratio becomes materially inaccurate (early recomputation year). If the taxpayer's historic absorption ratio is materially inaccurate, as defined in paragraph (b)(4)(ii)(C)(4) of this section, the taxpayer must use its actual absorption ratios computed using the simplified production method beginning with the early recomputation year and throughout the updated test period. The taxpayer must resume using the historic absorption ratio (determined with reference to the updated test period) in the third taxable year following the early recomputation year.

(4) *Materially inaccurate.* For purposes of this paragraph (b)(4), an historic absorption ratio becomes materially inaccurate in a taxable year that—

(i) The taxpayer's actual absorption ratio computed using the simplified production method deviates by more than 50 percent and by more than one-half of one percentage point from the taxpayer's historic absorption ratio for that year; and

(ii) The amount of additional section 263A costs capitalizable to eligible property remaining on hand at the close of that year under the simplified production

method (using the taxpayer's actual absorption ratio) deviates by more than \$100,000 from the amount of additional section 263A costs capitalizable to that property under the simplified production method with historic absorption ratio election for that year.

\* \* \* \* \*

$$\text{Historic absorption ratio} = \frac{\$3,500,000 + 4,000,000 + 4,500,000}{\$75,000,000 + 80,000,000 + 85,000,000} = 5\%$$

(iii) In 1998, K incurs \$90,000,000 of section 471 costs of which \$15,000,000 remain in inventory at the end of the year. In addition, K places \$50,000,000 of plant and equipment into service. K's book depreciation on the new plant and equipment is \$5,000,000, while K's tax depreciation on

(v) The difference between K's actual absorption ratio (10%) under the simplified production method for 1998 and K's historic absorption ratio (5%) is 5%, which is greater than 50 percent of K's historic absorption ratio for that year (5% x 50% = 2.5%). Under the simplified production method without the historic absorption ratio election, K determines the additional section 263A costs allocable to its ending inventory by multiplying its actual absorption ratio (10%) by the section 471 costs remaining in its ending inventory as follows:

$$\text{Add'l section 263A costs} = 10\% \times \$15,000,000 = \$1,500,000$$

(vi) Under the simplified production method using the historic absorption ratio, K determines the additional section 263A costs allocable to its ending inventory by multiplying its historic absorption ratio (5%) by the section 471 costs remaining in its ending inventory as follows:

$$\text{Add'l section 263A costs} = 5\% \times \$15,000,000 = \$750,000$$

(vii) The difference between the amount of additional section 263A costs allocable to eligible property remaining on hand at the close of 1998 under the simplified production method using the taxpayer's actual absorption ratio and the amount of additional section 263A costs allocable to that property under the simplified production method with historic absorption ratio election (\$1,500,000 - \$750,000 = \$750,000) exceeds \$100,000. Accordingly, K's historic absorption ratio is materially inaccurate for 1998.

(viii) Since K's historic absorption ratio is materially inaccurate in 1998, K's qualifying period closes immediately prior to the beginning of K's 1998 taxable year. Therefore, K must update its test period beginning in 1998. K must use actual absorption ratios under the simplified production method beginning in 1998 and throughout the updated test period (1999 and 2000). K must resume using the historic absorption ratio (determined with reference to the updated test period) in 2001, the third taxable year following 1998.

*Example 3.* (i) Taxpayer L properly elects to use the historic absorption ratio with the simplified pro-

(vi) *Examples.* The provisions of this paragraph (b)(4) are illustrated by the following examples:

*Example 1.* \* \* \*

*Example 2.* (i) Taxpayer K uses the FIFO method of accounting for inventories and properly elects to use the historic absorption ratio with the simplified production method for 1998. K identifies the following costs incurred during the test period:

1995:  
Add'l section 263A costs — \$3,500,000 Section 471 costs — \$75,000,000  
1996:  
Add'l section 263A costs — \$4,000,000 Section 471 costs — \$80,000,000  
1997:  
Add'l section 263A costs — \$4,500,000 Section 471 costs — \$85,000,000

(ii) Therefore, K computes a 5% historic absorption ratio as follows:

the new plant and equipment is \$10,000,000. K's book depreciation is a section 471 cost as described in §1.263A-1(d)(2) and the excess of K's tax depreciation over K's book depreciation, \$5,000,000, is an additional section 263A cost. K also has \$4,500,000 in other additional section 263A costs.

(iv) K must determine whether K's historic absorption ratio is materially inaccurate in 1998. Under the simplified production method without the historic absorption ratio election, K determines its actual absorption ratio for 1998 as follows:

$$\text{Actual absorption Ratio} = \frac{\$4,500,000 + \$5,000,000}{\$90,000,000 + \$5,000,000} = 10\%$$

duction method for 1999. L computes a 10% historic absorption ratio. On average, L's inventory turns over approximately fifteen times a year.

(ii) In 1999, L incurs \$8,000,000 of section 471 costs of which \$500,000 remain in inventory at the end of the year. In addition, L places \$5,000,000 of plant and equipment into service. The difference between L's tax depreciation on the new plant and equipment and L's book depreciation on that plant and equipment for 1999 is \$500,000, which is an additional section 263A cost. There were no other changes in L's additional 263A costs.

(iii) L can determine, without calculating an actual absorption ratio, that its historic absorption ratio is not materially inaccurate for 1999. The difference between the amount of additional section 263A costs allocated to its ending inventory using its actual absorption ratio and the amount of additional section 263A costs allocated to its ending inventory using its historic absorption ratio will not exceed \$100,000 and, therefore, L does not fall within the specific dollar amount test of paragraph (b)(4)(ii)(C)(4)(ii) of this section. Although L's additional section 263A costs increased by over \$100,000 in 1999 (they increased by \$500,000) as a result of placing the plant and equipment into service, only a portion of that amount will be allocated to ending inventory. L's inventory turns over approximately fifteen times a year. Of the \$500,000 of additional section 263A costs incurred as the result of placing the plant and equipment into service in 1999, only about \$33,000 (\$500,000 ÷ 15) will be allocated to ending inventory. Since \$33,000 is well below the \$100,000 threshold, L can determine without calculating an actual absorption ratio for 1999 that its historic absorption ratio is not materially inaccurate. Since L's historic absorption ratio is not materially inaccurate in 1999, L's qualifying period does not terminate early.

\* \* \* \* \*

Par. 3. Section 1.263A-3 is amended as follows:

1. Paragraphs (d)(4)(ii)(C)(1) and (2) are revised;

2. New paragraphs (d)(4)(ii)(C)(3) and (4) are added;

3. Paragraph (d)(4)(vi) is amended by:
  - a. Revising the paragraph heading and introductory text;
  - b. Redesignating the *Example* as *Example 1*;
  - c. Adding new *Example 2*.

The revisions and additions read as follows:

*§1.263A-3 Rules relating to property acquired for resale.*

\* \* \* \* \*

- (d) \* \* \*
- (4) \* \* \*
- (ii) \* \* \*

(C) *Qualifying period*—(1) *In general.* A qualifying period generally includes each of the first five taxable years beginning with the first taxable year after a test period (or an updated test period). However, a qualifying period may be extended under the provisions of paragraph (d)(4)(ii)(C)(2) of this section or may terminate early under the provisions of paragraph (d)(4)(ii)(C)(3) of this section.

(2) *Extension of qualifying period.* In the first taxable year following the close of each qualifying period, (e.g., the sixth taxable year following the test period), the taxpayer must compute the actual combined absorption ratio under the simplified resale method. If the actual combined absorption ratio computed for this taxable year (the recomputation year) is within one-half of one percentage point

(plus or minus) of the historic absorption ratio used in determining capitalizable costs for the qualifying period (e.g., the previous five taxable years), the qualifying period is extended to include the recomputation year and the following five taxable years (or a shorter period if the qualifying period is terminated early under the provisions of paragraph (d)(4)(ii)(C)(3) of this section), and the taxpayer must continue to use the historic absorption ratio throughout the extended qualifying period. If, however, the actual combined absorption ratio computed for the recomputation year is not within one-half of one percentage point (plus or minus) of the historic absorption ratio, the taxpayer must use actual combined absorption ratios beginning with the recomputation year under the simplified resale method and throughout the updated test period. The taxpayer must resume using the historic absorption ratio (determined with reference to the updated test period) in the third taxable year following the recomputation year.

(3) *Earlier termination of the qualifying period.* For taxable years beginning after [INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER], a qualifying period closes immediately prior to a taxable

year in which the taxpayer's historic absorption ratio becomes materially inaccurate (early recomputation year). If the taxpayer's historic absorption ratio is materially inaccurate, as defined in paragraph (d)(4)(ii)(C)(4) of this section, the taxpayer must use its actual combined absorption ratios computed using the simplified resale method beginning with the early recomputation year and throughout the updated test period. The taxpayer must resume using the historic absorption ratio (determined with reference to the updated test period) in the third taxable year following the early recomputation year.

(4) *Materially inaccurate.* For purposes of this paragraph (d)(4), an historic absorption ratio becomes materially inaccurate in a taxable year that—

(i) The taxpayer's actual combined absorption ratio computed using the simplified resale method deviates by more than 50 percent and by more than one-half of one percentage point from the taxpayer's historic absorption ratio for that year; and

(ii) The amount of additional section 263A costs capitalizable to eligible property remaining on hand at the close of that year under the simplified resale method (using the taxpayer's actual combined absorption ratio) deviates by more than

$$\text{Historic absorption ratio} = \frac{\$2,000,000 + 2,500,000 + 3,000,000}{\$45,000,000 + 50,000,000 + 55,000,000} = 5\%$$

(iii) In 1999, W decides to automate part of its repackaging activities. Accordingly, W places new repackaging equipment into service. The repackaging equipment has a basis of \$15,000,000 for tax purposes. W's tax depreciation on the new equipment for 1999 is \$3,000,000. This depreciation allowance is an additional section 263A cost and is a handling cost as defined in paragraph (c)(4) of this section. As a result of the new equipment, W's direct labor costs with respect to its repackaging activities decrease by \$500,000 during 1999. In 1999, W incurs \$60,000,000 of section 471 costs, of which \$6,000,000 remain on hand at the end of the year. W identifies \$6,000,000 of storage and handling costs, including W's tax depreciation on the new equipment and taking into account the reduction in direct labor costs, and \$450,000 of purchasing costs incurred in 1999.

(iv) W must determine whether W's historic absorption ratio is materially inaccurate in 1999. In order to do so, W calculates W's actual combined absorption ratio for 1999 as follows:

$$\begin{aligned} \text{Storage \& handling costs} &= \frac{\$6,000,000}{\$60,000,000} = 10\% \\ \text{absorption ratio} & \\ \text{Purchasing costs} &= \frac{\$450,000}{\$60,000,000} = 0.75\% \\ \text{absorption ratio} & \end{aligned}$$

Combined absorption ratio = 10% + 0.75% = 10.75%

(v) The difference between W's actual combined absorption ratio (10.75%) under the simplified resale method for 1999 and W's historic absorption ratio (5%) is 5.75%, which is greater than 50 percent of W's historic absorption ratio for that year (5% × 50% = 2.5%). Under the simplified resale method without the historic absorption ratio election, W determines the additional section 263A costs allocable to its ending inventory by multiplying its actual combined absorption ratio (10.75%) by the section 471 costs remaining in its ending inventory as follows:

$$\text{Add'l section 263A costs} = 10.75\% \times \$6,000,000 = \$645,000$$

(vi) Under the simplified resale method using the historic absorption ratio, W determines the additional section 263A costs

\$100,000 from the amount of additional section 263A costs capitalizable to that property under the simplified resale method with historic absorption ratio election for that year.

\* \* \* \* \*

(vi) *Examples.* The provisions of this paragraph (d)(4) are illustrated by the following examples:

*Example 1.* \* \* \*

*Example 2.* (i) Taxpayer W operates a mail-order retail business and uses the FIFO method of accounting for inventories. In 1996, 1997 and 1998, W used the simplified resale method without the historic absorption ratio election with the variation permitted in paragraph (d)(3)(iii)(A) of this section, exclusion of beginning inventories from the denominator in the storage and handling costs absorption ratio formula. Taxpayer W elects to use the historic absorption ratio with the simplified resale method for 1999. W identifies the following costs incurred during the test period:

1996:

Add'l section 263A costs — \$2,000,000 Section 471 costs — \$45,000,000

1997:

Add'l section 263A costs — \$2,500,000 Section 471 costs — \$50,000,000

1998:

Add'l section 263A costs — \$3,000,000 Section 471 costs — \$55,000,000

(ii) Therefore, W computes a 5% historic absorption ratio as follows:

allocable to its ending inventory by multiplying its historic absorption ratio (5%) by the section 471 costs remaining in its ending inventory as follows:

$$\text{Add'l section 263A costs} = 5\% \times \$6,000,000 = \$300,000$$

(vii) The difference between the amount of additional section 263A costs allocable to eligible property remaining on hand at the close of 1999 under the simplified resale method using the taxpayer's actual combined absorption ratio and the amount of additional section 263A costs allocable to that property under the simplified resale method with historic absorption ratio election (\$645,000 – \$300,000 = \$345,000) exceeds \$100,000. Accordingly, W's historic absorption ratio is materially inaccurate for 1999.

(viii) Since W's historic absorption ratio was materially inaccurate in 1999,

W's qualifying period closes immediately prior to the beginning of W's 1999 taxable year. Therefore, W must update its test period beginning in 1999. W must use actual combined absorption ratios under the simplified resale method beginning in 1999 and throughout the updated test period (2000 and 2001). W must re-

sume using the historic absorption ratio (determined with reference to the updated test period) in 2002, the third taxable year following 1999.

\* \* \* \* \*

Robert E. Wenzel,  
*Deputy Commissioner of  
Internal Revenue.*

(Filed by the Office of the Federal Register on May 21, 1999, 8:45 a.m., and published in the issue of the Federal Register for May 24, 1999, 64 F.R. 27936)