change its method of accounting to comply with paragraph (h)(2)(i)(D) of this section for its first taxable year ending on or after August 2, 2005, on or before the date that is 30 days after the end of the taxable year for which the change is requested.

(l) *Effective date.* Paragraphs (h)(2)(i)(D), (k), and (l) of this section apply for taxable years ending on or after August 2, 2005.

[T.D. 8482, 58 FR 42209, Aug. 9, 1993]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.263A–1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and on GPO Access.

§ 1.263A–2 Rules relating to property produced by the taxpayer.

(a) *In general.* Section 263A applies to real property and tangible personal property produced by a taxpayer for use in its trade or business or for sale to its customers. In addition, section 263A applies to property produced for a taxpayer under a contract with another party. The principal terms related to the scope of section 263A with respect to producers are provided in this paragraph (a). See §1.263A–1(b)(11) for an exception in the case of certain de minimis property provided to customers incident to the provision of services.

(1) *Produce*—(i) *In general.* For purposes of section 263A, produce includes the following: construct, build, install, manufacture, develop, improve, create, raise, or grow.

(ii) *Ownership*—(A) *General rule.* Except as provided in paragraphs (a)(1)(ii)(B) and (C) of this section, a taxpayer is not considered to be producing property unless the taxpayer is considered an owner of the property produced under federal income tax principles. The determination as to whether a taxpayer is an owner is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxpayer. A taxpayer may be considered an owner of property produced, even though the taxpayer does not have legal title to the property.

(B) *Property produced for the taxpayer under a contract*—(*1*) *In general.* Property produced for the taxpayer under a contract with another party is treated as property produced by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs with respect to the property. A taxpayer has made payment under this section if the transaction would be considered payment by a taxpayer using the cash receipts and disbursements method of accounting.

(*2*) *Definition of a contract*—(*i*) *General rule.* Except as provided under paragraph (a)(1)(ii)(B)(*2*)(*ii*) of this section, a contract is any agreement providing for the production of property if the agreement is entered into before the production of the property to be delivered under the contract is completed. Whether an agreement exists depends on all the facts and circumstances. Facts and circumstances indicating an agreement include, for example, the making of a prepayment, or an arrangement to make a prepayment, for property prior to the date of the completion of production of the property, or the incurring of significant expenditures for property of specialized design or specialized application that is not intended for self-use.

(*ii*) *Routine purchase order exception.* A routine purchase order for fungible property is not treated as a contract for purposes of this section. An agreement will not be treated as a routine purchase order for fungible property, however, if the contractor is required to make more than de minimis modifications to the property to tailor it to the customer's specific needs, or if at the time the agreement is entered into, the customer knows or has reason to know that the contractor cannot satisfy the agreement within 30 days out of existing stocks and normal production of finished goods.

(C) *Home construction contracts.* Section 460(e)(1) provides that section 263A applies to a home construction contract unless that contract will be completed within two years of the contract commencement date and the taxpayer's average annual gross receipts for the three preceding taxable years do not exceed $10,000,000. Section 263A applies to such a contract even if the contractor is not considered the owner of the property produced under the contract under federal income tax principles.

(2) *Tangible personal property*—(i) *General rule.* In general, section 263A applies to the costs of producing tangible personal property, and not to the costs of producing intangible property. For example, section 263A applies to the costs manufacturers incur to produce goods, but does not apply to the costs financial institutions incur to originate loans.

(ii) *Intellectual or creative property.* For purposes of determining whether a taxpayer producing intellectual or creative property is producing tangible personal property or intangible property, the term tangible personal property includes films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds by the creator thereof. Other similar property for this purpose generally means intellectual or creative property for which, as costs are incurred in producing the property, it is intended (or is reasonably likely) that any tangible medium in which the property is embodied will be mass distributed by the creator or any one or more third parties in a form that is not substantially altered. However, any intellectual or creative property that is embodied in a tangible medium that is mass distributed merely incident to the distribution of a principal product or good of the creator is not other similar property for these purposes.

(A) *Intellectual or creative property that is tangible personal property.* Section 263A applies to tangible personal property defined in this paragraph (a)(2) without regard to whether such property is treated as tangible or intangible property under other sections of the Internal Revenue Code. Thus, for example, section 263A applies to the costs of producing a motion picture or researching and writing a book even though these assets may be considered intangible for other purposes of the Internal Revenue Code. Tangible personal property includes, for example, the following:

(*1*) *Books.* The costs of producing and developing books (including teaching aids and other literary works) required to be capitalized under this section include costs incurred by an author in researching, preparing, and writing the book. (However, see section 263A(h), which provides an exemption from the capitalization requirements of section 263A in the case of certain free-lance authors.) In addition, the costs of producing and developing books include prepublication expenditures incurred by publishers, including payments made to authors (other than commissions for sales of books that have already taken place), as well as costs incurred by publishers in writing, editing, compiling, illustrating, designing, and developing the books. The costs of producing a book also include the costs of producing the underlying manuscript, copyright, or license. (These costs are distinguished from the separately capitalizable costs of printing and binding the tangible medium embodying the book (e.g., paper and ink).) 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.

(*2*) *Sound recordings.* 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.

(B) *Intellectual or creative property that is not tangible personal property.* Items that are not considered tangible personal property within the meaning of section 263A(b) and paragraph (a)(2)(ii) of this section include:

(*1*) *Evidences of value.* Tangible personal property does not include property that is representative or evidence of value, such as stock, securities, debt instruments, mortgages, or loans.

(*2*) *Property provided incident to services.* Tangible personal property does not include de minimis property provided to a client or customer incident to the provision of services, such as wills prepared by attorneys, or blueprints prepared by architects. See §1.263A–1(b)(11).

(3) *Costs required to be capitalized by producers*—(i) *In general.* Except as specifically provided in section 263A(f)

with respect to interest costs, producers must capitalize direct and indirect costs properly allocable to property produced under section 263A, without regard to whether those costs are incurred before, during, or after the production period (as defined in section 263A(f)(4)(B)).

(ii) *Pre-production costs.* 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.

(iii) *Post-production costs.* Generally, producers must capitalize all indirect costs incurred subsequent to completion of production that are properly allocable to the property produced. Thus, for example, storage and handling costs incurred while holding the property produced for sale after production must be capitalized to the property to the extent properly allocable to the property. However, see §1.263A–3(c) for exceptions.

(4) *Practical capacity concept.* Notwithstanding any provision to the contrary, the use, directly or indirectly, of the practical capacity concept is not permitted under section 263A. For purposes of section 263A, the term practical capacity concept means any concept, method, procedure, or formula (such as the practical capacity concept described in §1.471–11(d)(4)) whereunder fixed costs are not capitalized because of the relationship between the actual production at the taxpayer's production facility and the practical capacity of the facility. For purposes of this section, the practical capacity of a facility includes either the practical capacity or theoretical capacity of the facility, as defined in §1.471–11(d)(4), or any similar determination of productive or operating capacity. The practical capacity concept may not be used with respect to any activity to which section 263A applies (i.e., production or resale activities). A taxpayer shall not be considered to be using the practical capacity concept solely because the taxpayer properly does not capitalize costs described in §1.263A–1(e)(3)(iii)(E), relating to certain costs attributable to temporarily idle equipment.

(5) *Taxpayers required to capitalize costs under this section.* This section generally applies to taxpayers that produce property. If a taxpayer is engaged in both production activities and resale activities, the taxpayer applies the principles of this section as if it read production or resale activities, and by applying appropriate principles from §1.263A–3. If a taxpayer is engaged in both production and resale activities, the taxpayer may elect the simplified production method provided in this section, but generally may not elect the simplified resale method discussed in §1.263A–3(d). If elected, the simplified production method must be applied to all eligible property produced and all eligible property acquired for resale by the taxpayer.

(b) *Simplified production method*—(1) *Introduction.* This paragraph (b) provides a simplified method for determining the additional section 263A costs properly allocable to ending inventories of property produced and other eligible property on hand at the end of the taxable year.

(2) *Eligible property*—(i) *In general.* Except as otherwise provided in paragraph (b)(2)(ii) of this section, the simplified production method, if elected for any trade or business of a producer, must be used for all production and resale activities associated with any of the following categories of property to which section 263A applies:

(A) *Inventory property.* Stock in trade or other property properly includible in the inventory of the taxpayer.

(B) *Non-inventory property held for sale.* Non-inventory property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(C) *Certain self-constructed assets*. Self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property produced by the taxpayer or other property produced by the taxpayer and held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(D) *Self-constructed tangible personal property produced on a routine and repetitive basis—(1) In general*. Self-constructed tangible personal property produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business. Self-constructed tangible personal property is produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business when units of tangible personal property (as defined in §1.263A–10(c)) are mass-produced, that is, numerous substantially identical assets are manufactured within a taxable year using standardized designs and assembly line techniques, and either the applicable recovery period of the property determined under section 168(c) is not longer than 3 years or the property is a material or supply that will be used and consumed within 3 years of being produced. For purposes of this paragraph (b)(2)(i)(D), the applicable recovery period of the assets will be determined at the end of the taxable year in which the assets are placed in service for purposes of §1.46–3(d). Subsequent changes to the applicable recovery period after the assets are placed in service will not affect the determination of whether the assets are produced on a routine and repetitive basis for purposes of this paragraph (b)(2)(i)(D).

(2) *Examples*. The following examples illustrate this paragraph (b)(2)(i)(D):

Example 1. Y is a manufacturer of automobiles. During the taxable year Y produces numerous substantially identical dies and molds using standardized designs and assembly line techniques. The dies and molds have a 3-year applicable recovery period for purposes of section 168(c). Y uses the dies and molds to produce or process particular automobile components and does not hold them for sale. The dies and molds are produced on a routine and repetitive basis in the ordinary course of Y's business for purposes of this paragraph because the dies and molds are both mass-produced and have a recovery period of not longer than 3 years.

Example 2. Z is an electric utility that regularly manufactures and installs identical poles that are used in transmitting and distributing electricity. The poles have a 20-year applicable recovery period for purposes of section 168(c). The poles are not produced on a routine and repetitive basis in the ordinary course of Z's business for purposes of this paragraph because the poles have an applicable recovery period that is longer than 3 years.

(ii) *Election to exclude self-constructed assets*. At the taxpayer's election, the simplified production method may be applied within a trade or business to only the categories of inventory property and non-inventory property held for sale described in paragraphs (b)(2)(i) (A) and (B) of this section. Taxpayers electing to exclude the self- constructed assets, defined in paragraphs (b)(2)(i) (C) and (D) of this section, from application of the simplified production method must, however, allocate additional section 263A costs to such property in accordance with §1.263A–1 (f).

(3) *Simplified production method without historic absorption ratio election*—(i) *General allocation formula*—(A) *In general*. Except as otherwise provided in paragraph (b)(3)(iv) of this section, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year under the simplified production method are computed as follows:

$$\text{Absorption ratio} \times \text{section 471 costs remaining on hand at year end}$$

(B) *Effect of allocation*. The absorption ratio generally is multiplied by the section 471 costs remaining in ending inventory or otherwise on hand at the end of each taxable year in which the simplified production method is applied. The resulting product is the additional section 263A costs that are added to the taxpayer's ending section 471 costs to determine the section 263A costs that are capitalized. See, however, paragraph (b)(3)(iii) of this section for special rules applicable to LIFO taxpayers. Except as otherwise provided in this section or in §1.263A–1 or 1.263A–3, additional section 263A costs that are allocated to inventories on hand at the close of the taxable year under the simplified production method of this paragraph (b) are treated as inventory costs for all purposes of the Internal Revenue Code.

(ii) *Definitions*—(A) *Absorption ratio*. Under the simplified production method, the absorption ratio is determined as follows:

$$\frac{\text{Additional section 263A costs incurred during the taxable year}}{\text{Section 471 costs incurred during the taxable year}}$$

(*1*) *Additional section 263A costs incurred during the taxable year*. Additional section 263A costs incurred during the taxable year are defined as the additional section 263A costs described in §1.263A–1(d)(3) that a taxpayer incurs during its current taxable year.

(*2*) *Section 471 costs incurred during the taxable year*. Section 471 costs incurred during the taxable year are defined as the section 471 costs described in §1.263A–1(d)(2) that a taxpayer incurs during its current taxable year.

(B) *Section 471 costs remaining on hand at year end*. Section 471 costs remaining on hand at year end means the section 471 costs, as defined in §1.263A–1(d)(2), that a taxpayer incurs during its current taxable year which remain in its ending inventory or are otherwise on hand at year end. For LIFO inventories of a taxpayer, the section 471 costs remaining on hand at year end means the increment, if any, for the current year stated in terms of section 471 costs. See paragraph (b)(3)(iii) of this section.

(iii) *LIFO taxpayers electing the simplified production method*—(A) *In general*. Under the simplified production method, a taxpayer using a LIFO method must calculate a particular year's index (e.g., under §1.472–8(e)) without regard to its additional section 263A costs. Similarly, a taxpayer that adjusts current-year costs by applicable indexes to determine whether there has been an inventory increment or decrement in the current year for a particular LIFO pool must disregard the additional section 263A costs in making that determination.

(B) *LIFO increment*. If the taxpayer determines there has been an inventory increment, the taxpayer must state the amount of the increment in current-year dollars (stated in terms of section 471 costs). The taxpayer then multiplies this amount by the absorption ratio. The resulting product is the additional section 263A costs that must be added to the taxpayer's increment for the year stated in terms of section 471 costs.

(C) *LIFO decrement*. If the taxpayer determines there has been an inventory decrement, the taxpayer must state the amount of the decrement in dollars applicable to the particular year for which the LIFO layer has been invaded. The additional section 263A costs incurred in prior years that are applicable to the decrement are charged to cost of goods sold. The additional section 263A costs that are applicable to the decrement are determined by multiplying the additional section 263A costs allocated to the layer of the pool in which the decrement occurred by the ratio of the decrement (excluding additional section 263A costs) to the section 471 costs in the layer of that pool.

(iv) *De minimis rule for producers with total indirect costs of $200,000 or less*—(A) *In general*. If a producer using the simplified production method incurs $200,000 or less of total indirect costs in a taxable year, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year are deemed to be zero. Solely for purposes of this paragraph (b)(3)(iv), taxpayers are permitted to exclude any category of indirect costs (listed in §1.263A–1(e)(3)(iii)) that is not required to be capitalized (e.g., selling and distribution costs) in determining total indirect costs.

(B) *Related party and aggregation rules.* In determining whether the producer incurs $200,000 or less of total indirect costs in a taxable year, the related party and aggregation rules of §1.263A–3(b)(3) are applied by substituting total indirect costs for gross receipts wherever gross receipts appears.

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

Example 1. FIFO inventory method. (i) Taxpayer J uses the FIFO method of accounting for inventories. J's beginning inventory for 1994 (all of which is sold during 1994) is $2,500,000 (consisting of $2,000,000 of section 471 costs and $500,000 of additional section 263A costs). During 1994, J incurs $10,000,000 of section 471 costs and $1,000,000 of additional section 263A costs. J's additional section 263A costs include capitalizable mixed service costs computed under the simplified service cost method as well as other allocable costs. J's section 471 costs remaining in ending inventory at the end of 1994 are $3,000,000. J computes its absorption ratio for 1994, as follows:

$$\frac{\text{Additional section 263A costs incurred during 1994}}{\text{Section 471 costs incurred during 1994}} = \frac{\$1{,}000{,}000}{\$10{,}000{,}000} = 10\%$$

(ii) Under the simplified production method, J determines the additional section 263A costs allocable to its ending inventory by multiplying the absorption ratio by the section 471 costs remaining in its ending inventory:

$$\text{Additional section 263A costs} = 10\% \times \$3{,}000{,}000 = \$300{,}000$$

(iii) J adds this $300,000 to the $3,000,000 of section 471 costs remaining in its ending inventory to calculate its total ending inventory of $3,300,000. The balance of J's additional section 263A costs incurred during 1994, $700,000, ($1,000,000 less $300,000) is taken into account in 1994 as part of J's cost of goods sold.

Example 2. LIFO inventory method. (i) Taxpayer K uses a dollar-value LIFO inventory method. K's beginning inventory for 1994 is $2,500,000 (consisting of $2,000,000 of section 471 costs and $500,000 of additional section 263A costs). During 1994, K incurs $10,000,000 of section 471 costs and $1,000,000 of additional section 263A costs. K's 1994 LIFO increment is $1,000,000 ($3,000,000 of section 471 costs in ending inventory less $2,000,000 of section 471 costs in beginning inventory).

(ii) To determine the additional section 263A costs allocable to its ending inventory, K multiplies the 10% absorption ratio ($1,000,000 of additional section 263A costs divided by $10,000,000 of section 471 costs) by the $1,000,000 LIFO increment. Thus, K's additional section 263A costs allocable to its ending inventory are $100,000 ($1,000,000 multiplied by 10%). This $100,000 is added to the $1,000,000 to determine a total 1994 LIFO increment of $1,100,000. K's ending inventory is $3,600,000 (its beginning inventory of $2,500,000 plus the $1,100,000 increment). The balance of K's additional section 263A costs incurred during 1994, $900,000 ($1,000,000 less $100,000), is taken into account in 1994 as part of K's cost of goods sold.

(iii) In 1995, K sells one-half of the inventory in its 1994 LIFO increment. K must include in its cost of goods sold for 1995 the amount of additional section 263A costs relating to this inventory, $50,000 (one-half of the tional section 263A costs capitalized in 1994 ending inventory, or $100,000).

Example 3. LIFO pools. (i) Taxpayer U begins its business in 1994 and adopts the LIFO inventory method. During 1994, L incurs $10,000 of section 471 costs and $1,000 of additional section 263A costs. At the end of 1994, L's ending inventory includes $3,000 of section 471 costs contained in three LIFO pools (X, Y, and Z) as shown below. Under the simplified production method, L computes its absorption ratio and inventory for 1994 as follows:

$$\frac{\text{Additional section 263A costs incurred during 1994}}{\text{Section 471 costs incurred during 1994}} = \frac{\$1,000}{\$10,000} = 10\%$$

	Total	X	Y	Z
1994:				
Ending section 471 costs	$3,000	$1,600	$600	$800
Additional section 263A costs (10%)	300	160	60	80
1994 ending inventory	$3,300	$1,760	$660	$880

(ii) During 1995, L incurs $2,000 of section 471 costs as shown below and $400 of additional section 263A costs. Moreover, L sells goods from pools X, Y, and Z having a total cost of $1,000. L computes its absorption ratio and inventory for 1995:

$$\frac{\text{Additional section 263A costs incurred during 1995}}{\text{Section 471 costs incurred during 1995}} = \frac{\$400}{\$2,000} = 20\%$$

	Total	X	Y	Z
1995:				
Beginning section 471 costs	$3,000	$1,600	$600	$800
1995 section 471 costs	2,000	1,500	300	200
Section 471 cost of goods sold	(1,000)	(300)	(300)	(400)
1995 ending section 471 costs	$4,000	$2,800	$600	$600
Consisting of:				
1994 layer	$2,800	$1,600	$600	$600
1995 layer	1,200	1,200	....	....
	$4,000	$2,800	$600	$600
Additional section 263A costs:				
1994 (10%)	$280	$160	$60	$60
1995 (20%)	240	240	....	....
	$520	$400	$60	$60
1995 ending inventory	$4,520	$3,200	$660	$660

(iii) In 1995, L experiences a $200 decrement in pool Z. Thus, L must charge the additional section 263A costs incurred in prior years applicable to the decrement to 1995's cost of goods sold. To do so, L determines a ratio by dividing the decrement by the section 471 costs in the 1994 layer ($200 divided by $800, or 25%). L then multiplies this ratio (25%) by the additional section 263A costs in the 1994 layer ($80) to determine the additional section 263A costs applicable to the decrement ($20). Therefore, $20 is taken into account by L in 1995 as part of its cost of goods sold ($80 multiplied by 25%).

(4) *Simplified production method with historic absorption ratio election*—(i) *In general*. This paragraph (b)(4) generally permits producers using the simplified production method to elect a historic absorption ratio in determining additional section 263A costs allocable to eligible property remaining on hand at the close of their taxable years. Except as provided in paragraph (b)(4)(v) of this section, a taxpayer may only make a historic absorption ratio election if it has used the simplified production method for three or more consecutive taxable years immediately prior to the year of election and has capitalized additional section 263A costs using an actual absorption ratio (as defined under

paragraph (b)(3)(ii) of this section) for its three most recent consecutive taxable years. This method is not available to a taxpayer that is deemed to have zero additional section 263A costs under paragraph (b)(3)(iv) of this section. The historic absorption ratio is used in lieu of an actual absorption ratio computed under paragraph (b)(3)(ii) of this section and is based on costs capitalized by a taxpayer during its test period. If elected, the historic absorption ratio must be used for each taxable year within the qualifying period described in paragraph (b)(4)(ii)(C) of this section.

(ii) *Operating rules and definitions*—(A) *Historic absorption ratio*. (*1*) The historic absorption ratio is equal to the following ratio:

$$\frac{\text{Additional section 263A costs incurred during the test period}}{\text{Section 471 costs incurred during the test period}}$$

(*2*) Additional section 263A costs incurred during the test period are defined as the additional section 263A costs described in §1.263A–1(d)(3) that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(*3*) Section 471 costs incurred during the test period mean the section 471 costs described in §1.263A–1(d)(2) that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(*B*) *Test period—(1) In general*. The test period is generally the three taxable-year period immediately prior to the taxable year that the historic absorption ratio is elected.

(*2*) *Updated test period*. The test period begins again with the beginning of the first taxable year after the close of a qualifying period. This new test period, the updated test period, is the three taxable-year period beginning with the first taxable year after the close of the qualifying period as defined in paragraph (b)(4)(ii)(C) of this section.

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

(*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 (i.e., the previous five taxable years), the qualifying period is extended to include the recomputation year and the following five taxable years, 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.

(iii) *Method of accounting*—(A) *Adoption and use*. The election to use the historic absorption ratio is a method of accounting. A taxpayer using the simplified production method may elect the historic absorption ratio in any taxable year if permitted under this paragraph (b)(4), provided the taxpayer has not obtained the Commissioner's consent to revoke the historic absorption ratio election within its prior six taxable years. The election is to be effected on a cut-off basis, and thus, no adjustment under section 481(a) is required or permitted. The use of a historic absorption ratio has no effect on other methods of accounting adopted by the taxpayer and used in conjunction with the simplified production method in determining its section 263A costs. Accordingly, in computing its actual absorption ratios, the taxpayer must use the same methods of accounting used in computing its historic absorption ratio during its most recent test period unless the taxpayer obtains the consent of the Commissioner. Finally, for purposes of this paragraph (b)(4)(iii), the recomputation of the historic absorption ratio during an updated test period and the change from a historic absorption ratio to an actual absorption ratio by reason of the requirements of this paragraph (b)(4) are not considered changes in methods of accounting under section 446(e) and, thus, do not require the consent of the Commissioner or any adjustments under section 481(a).

(B) *Revocation of election.* A taxpayer may only revoke its election to use the historic absorption ratio with the consent of the Commissioner in a manner prescribed under section 446(e) and the regulations thereunder. Consent to the change for any taxable year that is included in the qualifying period (or an extended qualifying period) will be granted only upon a showing of unusual circumstances.

(iv) *Reporting and recordkeeping requirements*—(A) *Reporting.* A taxpayer making an election under this paragraph (b)(4) must attach a statement to its federal income tax return for the taxable year in which the election is made showing the actual absorption ratios determined under the simplified production method during its first test period. This statement must disclose the historic absorption ratio to be used by the taxpayer during its qualifying period. A similar statement must be attached to the federal income tax return for the first taxable year within any subsequent qualifying period (i.e., after an updated test period).

(B) *Recordkeeping.* A taxpayer must maintain all appropriate records and details supporting the historic absorption ratio until the expiration of the statute of limitations for the last year for which the taxpayer applied the particular historic absorption ratio in determining additional section 263A costs capitalized to eligible property.

(v) *Transition rules.* Taxpayers will be permitted to elect a historic absorption ratio in their first, second, or third taxable year beginning after December 31, 1993, under such terms and conditions as may be prescribed by the Commissioner. Taxpayers are eligible to make an election under these transition rules whether or not they previously used the simplified production method. A taxpayer making such an election must recompute (or compute) its additional section 263A costs, and thus, its historic absorption ratio for its first test period as if the rules prescribed in this section and §§ 1.263A–1 and 1.263A–3 had applied throughout the test period.

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

Example. (i) Taxpayer M uses the FIFO method of accounting for inventories and for 1994 elects to use the historic absorption ratio with the simplified production method. After recomputing its additional section 263A costs in accordance with the transition rules of paragraph (b)(4)(v) of this section, M identifies the following costs incurred during the test period:

1991:
  Add'l section 263A costs—$100
  Section 471 costs—$3,000
1992:
  Add'l section 263A costs—$200
  Section 471 costs—$4,000
1993:
  Add'l section 263A costs—$300
  Section 471 costs—$5,000

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

$$\text{Historic absorption ratio} = \frac{\$100 + 200 + 300}{\$3{,}000 + 4{,}000 + 5{,}000} = \frac{\$600}{\$12{,}000} = 5\%$$

(iii) In 1994, M incurs $10,000 of section 471 costs of which $3,000 remain in inventory at the end of the year. Under the simplified production method using a historic absorption ratio, M 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:

$$\text{Additional section 263A costs} = 5\% \times \$3{,}000 = \$150$$

(iv) To determine its ending inventory under section 263A, M adds the additional section 263A costs allocable to ending inventory to its section 471 costs remaining in ending inventory ($3,150=$150+$3,000). The balance of M's additional section 263A costs incurred during 1994 is taken into account in 1994 as part of M's cost of goods sold.

(v) M's qualifying period ends with the close of its 1998 taxable year. Therefore, 1999 is a recomputation year in which M must compute its actual absorption ratio. M determines its actual absorption ratio for 1999 to be 5.25% and compares that ratio to its historic absorption ratio (5.0%). Therefore, M must continue to use its historic absorption ratio of 5.0% throughout an extended qualifying period, 1999 through 2004 (the recomputation year and the following five taxable years).

(vi) If, instead, M's actual absorption ratio for 1999 were not between 4.5% and 5.5%, M's qualifying period would end and M would be required to compute a new historic absorption ratio with reference to an updated test period of 1999, 2000, and 2001. Once M's historic absorption ratio is determined for the updated test period, it would be used for a new qualifying period beginning in 2002.

(c) *Additional simplified methods for producers*. The Commissioner may prescribe additional elective simplified methods by revenue ruling or revenue procedure.

(d) *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.

(e) *Change in method of accounting*—(1) *In general*. A change in a taxpayer's treatment of additional section 263A costs to comply with paragraph (b)(2)(i)(D) of this section is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations under those sections apply. See §1.263A–7. For a taxpayer's first taxable year ending on or after August 2, 2005, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with paragraph (b)(2)(i)(D) of this section, provided the taxpayer follows the administrative procedures, as modified by paragraphs (e)(2) through (4) of this section, issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002–9 (2002–1 CB 327), as modified and clarified by Announcement 2002–17 (2002–1 CB 561), modified and amplified by Rev. Proc. 2002–19 (2002–1 CB 696), and amplified, clarified, and modified by Rev. Proc. 2002–54 (2002–2 CB 432), and §601.601(d)(2)(ii)(*b*) of this chapter). For purposes of Form 3115, ''Application for Change in Accounting Method,'' the designated number for the automatic accounting method change authorized by this paragraph (e) is ''95.'' If Form 3115 is revised or renumbered, any reference in this section to that form is treated as a reference to the revised or renumbered form. Alternatively, notwithstanding the provisions of any administrative procedures that preclude a taxpayer from requesting the advance consent of the Commissioner to change a method of accounting that is required to be made pursuant to a published automatic change procedure, for its first taxable year ending on or after August 2, 2005, a taxpayer may request the advance consent of the Commissioner to change its method of accounting to comply with paragraph (b)(2)(i)(D) of this section, provided the taxpayer follows the administrative procedures, as modified by paragraphs (e)(2) through (5) of this section, for obtaining the advance consent of the Commissioner (for further guidance, for example, see Rev. Proc. 97–27 (1997–1 CB 680), as modified and amplified by Rev. Proc. 2002–19 (2002–1 CB 696), as amplified and clarified by Rev. Proc. 2002–54 (2002–2 CB 432), and

§ 601.601(d)(2)(ii)(*b*) of this chapter). For the taxpayer's second and subsequent taxable years ending on or after August 2, 2005, requests to secure the consent of the Commissioner must be made under the administrative procedures, as modified by paragraphs (e)(3) and (4) of this section, for obtaining the Commissioner's advance consent to a change in accounting method.

(2) *Scope limitations.* Any limitations on obtaining the automatic consent or advance consent of the Commissioner do not apply to a taxpayer seeking to change its method of accounting to comply with paragraph (b)(2)(i)(D) of this section for its first taxable year ending on or after August 2, 2005.

(3) *Audit protection.* A taxpayer that changes its method of accounting in accordance with this paragraph (e) to comply with paragraph (b)(2)(i)(D) of this section does not receive audit protection if its method of accounting for additional section 263A costs is an issue under consideration at the time the application is filed with the national office.

(4) *Section 481(a) adjustment.* A change in method of accounting to conform to paragraph (b)(2)(i)(D) of this section requires a section 481(a) adjustment. The section 481(a) adjustment period is two taxable years for a net positive adjustment for an accounting method change that is made to conform to paragraph (b)(2)(i)(D) of this section.

(5) *Time for requesting change.* Notwithstanding the provisions of § 1.446–1(e)(3)(i) and any contrary administrative procedure, a taxpayer may submit a request for advance consent to change its method of accounting to comply with paragraph (b)(2)(i)D) of this section for its first taxable year ending on or after August 2, 2005, on or before the date that is 30 days after the end of the taxable year for which the change is requested.

(f) *Effective date.* Paragraphs (b)(2)(i)(D), (e), and (f) of this section apply for taxable years ending on or after August 2, 2005.

[T.D. 8482, 58 FR 42219, Aug. 9, 1993, as amended by 59 FR 3318, 3319, Jan. 21, 1994; T.D. 8584, 59 FR 67197, Dec. 29, 1994; T.D. 9217, 70 FR 44469, Aug. 3, 2005; T.D. 9318, 72 FR 14677, Mar. 29, 2007]

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

(a) *Capitalization rules for property acquired for resale*—(1) *In general.* Section 263A applies to real property and personal property described in section 1221(1) acquired for resale by a retailer, wholesaler, or other taxpayer (reseller). However, section 263A does not apply to personal property described in section 1221(1) acquired for resale by a reseller whose average annual gross receipts for the three previous taxable years do not exceed $10,000,000 (small reseller). For this purpose, personal property includes both tangible and intangible property. Property acquired for resale includes stock in trade of the taxpayer or other property which is includible in the taxpayer's inventory if on hand at the close of the taxable year, and property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. See, however, § 1.263A–1(b)(11) for an exception for certain de minimis property provided to customers incident to the provision of services.

(2) *Resellers with production activities*—(i) *In general.* Generally, a taxpayer must capitalize all direct costs and certain indirect costs associated with real property and tangible personal property it produces. See § 1.263A–2(a). Thus, except as provided in paragraphs (a)(2)(ii) and (3) of this section, a reseller, including a small reseller, that also produces property must capitalize the additional section 263A costs associated with any property it produces.

(ii) *Exception for small resellers.* Under this paragraph (a)(2)(ii), a small reseller is not required to capitalize additional section 263A costs associated with any personal property that is produced incident to its resale activities, provided the production activities are de minimis (within the meaning of paragraph (a)(2)(iii) of this section).

(iii) *De minimis production activities*—(A) *In general.* (*1*) In determining whether a taxpayer's production activities are de minimis, all facts and circumstances must be considered. For example, the taxpayer must consider the volume of the production activities in its trade or business. Production activities are presumed de minimis if—