

§ 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—

(i) The gross receipts from the sale of the property produced by the reseller are less than 10 percent of the total gross receipts of the trade or business; and

(ii) The labor costs allocable to the trade or business' production activities are less than 10 percent of the reseller's total labor costs allocable to its trade or business.

(2) For purposes of this de minimis presumption, gross receipts has the same definition as provided in paragraph (b) of this section except that gross receipts are measured at the trade-or-business level rather than at the single-employer level.

(B) *Example.* The application of this paragraph (a)(2) may be illustrated by the following example:

Example—Small reseller with de minimis production activities. Taxpayer N is a small reseller in the retail grocery business whose average annual gross receipts for the three previous taxable years are less than \$10,000,000. N's grocery stores typically contain bakeries where customers may purchase baked goods produced by N. N's gross receipts from its bakeries are 5% of the entire grocery business. N's labor costs from its bakeries are 3% of its total labor costs allocable to the entire grocery business. Because both ratios are less than 10%, N's production activities are de minimis. Further, because N's production activities are incident to its resale activities, N is not required to capitalize any additional section 263A costs associated with its produced property.

(3) *Resellers with property produced under contract.* Generally, property produced for a taxpayer under a contract (within the meaning of § 1.263A-2(a)(1)(ii)(B)(2)) is treated as property produced by the taxpayer. See § 1.263A-2(a)(1)(ii)(B). However, a small reseller is not required to capitalize additional section 263A costs to personal property produced for it under contract with an unrelated person if the contract is entered into incident to the resale activities of the small reseller and the property is sold to its customers. For purposes of this paragraph, persons are related if they are described in section 267(b) or 707(b).

(4) *Use of the simplified resale method—*

(i) *In general.* Except as provided in paragraphs (a)(4)(ii) and (iii) of this section, a taxpayer may elect the simplified production method (as described

in § 1.263A-2(b)) but may not elect the simplified resale method (as described in paragraph (d) of this section) if the taxpayer is engaged in both production and resale activities with respect to the items of eligible property listed in § 1.263A-2(b)(2).

(ii) *Resellers with de minimis production activities.* A reseller otherwise permitted to use the simplified resale method in paragraph (d) of this section may use the simplified resale method if its production activities with respect to the items of eligible property listed in § 1.263A-2(b)(2) are de minimis (within the meaning of paragraph (a)(2)(iii) of this section) and incident to its resale of personal property described in section 1221(1).

(iii) *Resellers with property produced under a contract.* A reseller otherwise permitted to use the simplified resale method in paragraph (d) of this section may use the simplified resale method even though it has personal property produced for it (e.g., private label goods) under a contract with an unrelated person if the contract is entered into incident to its resale activities and the property is sold to its customers. For purposes of this paragraph (a)(4)(iii), persons are related if they are described in section 267(b) or 707(b).

(iv) *Application of simplified resale method.* A taxpayer that uses the simplified resale method and has de minimis production activities incident to its resale activities or property produced under contract must capitalize all costs allocable to eligible property produced using the simplified resale method.

(b) *Gross receipts exception for small resellers—(1) In general.* Section 263A does not apply to any personal property acquired for resale during any taxable year if the taxpayer's (or its predecessors') average annual gross receipts for the three previous taxable years (test period) do not exceed \$10,000,000. However, taxpayers that acquire real property for resale are subject to section 263A with respect to real property regardless of their gross receipts. See section 263A(b)(2)(B).

(i) *Test period for new taxpayers.* For purposes of applying this exception, if a taxpayer has been in existence for

less than three taxable years, the taxpayer determines its average annual gross receipts for the number of taxable years (including short taxable years) that the taxpayer (or its predecessor) has been in existence.

(ii) *Treatment of short taxable year.* In the case of a short taxable year, the taxpayer's gross receipts are annualized by—

(A) Multiplying the gross receipts of the short taxable year by 12; and

(B) Dividing the product determined in paragraph (b)(1)(ii)(A) of this section by the number of months in the short taxable year.

(2) *Definition of gross receipts*—(i) *In general.* Gross receipts are the total amount, as determined under the taxpayer's method of accounting, derived from all of the taxpayer's trades or businesses (e.g., revenues derived from the sale of inventory before reduction for cost of goods sold).

(ii) *Amounts excluded.* For purposes of this paragraph (b), gross receipts do not include amounts representing—

(A) Returns or allowances;

(B) Interest, dividends, rents, royalties, or annuities, not derived in the ordinary course of a trade or business;

(C) Receipts from the sale or exchange of capital assets, as defined in section 1221;

(D) Repayments of loans or similar instruments (e.g., a repayment of the principal amount of a loan held by a commercial lender);

(E) Receipts from a sale or exchange not in the ordinary course of business, such as the sale of an entire trade or business or the sale of property used in a trade or business as defined under section 1221(2); and

(F) Receipts from any activity other than a trade or business or an activity engaged in for profit.

(3) *Aggregation of gross receipts*—(i) *In general.* In determining gross receipts, all persons treated as a single employer under section 52(a) or (b), section 414(m), or any regulation prescribed under section 414 (or persons that would be treated as a single employer under any of these provisions if they had employees) shall be treated as one taxpayer. The gross receipts of a single employer (or the group) are determined by aggregating the gross receipts of all

persons (or the members) of the group, excluding any gross receipts attributable to transactions occurring between group members.

(ii) *Single employer defined.* A controlled group, which is treated as a single employer under section 52(a), includes members of a controlled group within the meaning of section 1563(a), regardless of whether such members would be treated as component members of such group under section 1563(b). (See § 1.52-1(c).) Thus, for example, the gross receipts of a franchised corporation that is treated as an excluded member for purposes of section 1563(b) are included in the single employer's gross receipts under this aggregation rule, if such corporation and the taxpayer were members of the same controlled group under section 1563(a).

(iii) *Gross receipts of a single employer.* The gross receipts of a single employer for the test period include the gross receipts of all group members (or their predecessors) that are members of the group as of the first day of the taxable year in issue, regardless of whether such persons were members of the group for any of the three preceding taxable years. The gross receipts of the single employer for the test period do not, however, include the gross receipts of any member that was a group member (including any predecessor) for any or all of the three preceding taxable years, and is no longer a group member as of the first day of the taxable year in issue. Any group member that has a taxable year of less than 12 months must annualize its gross receipts in accordance with paragraph (b)(1)(ii) of this section.

(iv) *Examples.* The provisions of this paragraph (b)(3) are illustrated by the following examples:

Example 1. Subsidiary acquired during the taxable year. A parent corporation, (P), has owned 100% of the stock of another corporation, (S1), continually since 1989. P and S1 are calendar year taxpayers. S1 acquires property for resale. On January 1, 1994, P acquires 100% of the stock of another calendar year corporation (S2). In determining whether S1's resale activities are subject to the provisions of section 263A for 1994, the gross receipts of P, S1, and S2 for 1991, 1992, and

1993 are aggregated, excluding the gross receipts, if any, attributable to transactions occurring between the three corporations.

Example 2. Subsidiary sold during the taxable year. Since 1989, a parent corporation, (P), has continually owned 100% of the stock of two other corporations, (S1) and (S2). The three corporations are calendar year taxpayers. S1 acquires property for resale. On December 31, 1993, P sells all of its stock in S2. In determining whether S1's resale activities are subject to the provisions of section 263A for 1994, only the gross receipts of P and S1 for 1991, 1992, and 1993 must be aggregated, excluding the gross receipts, if any, attributable to transactions occurring between the two corporations.

(c) *Purchasing, handling, and storage costs—(1) In general.* Generally, §1.263A-1(e) describes the types of costs that must be capitalized by taxpayers. Resellers must capitalize the acquisition cost of property acquired for resale, as well as indirect costs described in §1.263A-1(e)(3), which are properly allocable to property acquired for resale. The indirect costs most often incurred by resellers are purchasing, handling, and storage costs. This paragraph (c) provides additional guidance regarding each of these categories of costs. As provided in §1.263A-1(e), this paragraph (c) also applies to producers incurring purchasing, handling, and storage costs.

(2) *Costs attributable to purchasing, handling, and storage.* The costs attributable to purchasing, handling, and storage activities generally consist of direct and indirect labor costs (including the costs of pension plans and other fringe benefits); occupancy expenses including rent, depreciation, insurance, security, taxes, utilities and maintenance; materials and supplies; rent, maintenance, depreciation, and insurance of vehicles and equipment; tools; telephone; travel; and the general and administrative costs that directly benefit or are incurred by reason of the taxpayer's activities.

(3) *Purchasing costs—(i) In general.* Purchasing costs are costs associated with operating a purchasing department or office within a trade or business, including personnel costs (e.g., of buyers, assistant buyers, and clerical workers), relating to—

- (A) The selection of merchandise;
- (B) The maintenance of stock assortment and volume;

- (C) The placement of purchase orders;
- (D) The establishment and maintenance of vendor contacts; and

(E) The comparison and testing of merchandise.

(ii) *Determination of whether personnel are engaged in purchasing activities.* The determination of whether a person is engaged in purchasing activities is based upon the activities performed by that person and not upon the person's title or job classification. Thus, for example, although an employee's job function may be described in such a way as to indicate activities outside the area of purchasing (e.g., a marketing representative), such activities must be analyzed on the basis of the activities performed by that employee. If a person performs both purchasing and non-purchasing activities, the taxpayer must reasonably allocate the person's labor costs between these activities. For example, a reasonable allocation is one based on the amount of time the person spends on each activity.

(A) *1/3-2/3 rule for allocating labor costs.* A taxpayer may elect the 1/3-2/3 rule for allocating labor costs of persons performing both purchasing and non-purchasing activities. If elected, the taxpayer must allocate the labor costs of all such persons using the 1/3-2/3 rule. Under this rule—

(1) If less than one-third of a person's activities are related to purchasing, none of that person's labor costs are allocated to purchasing;

(2) If more than two-thirds of a person's activities are related to purchasing, all of that person's labor costs are allocated to purchasing; and

(3) In all other cases, the taxpayer must reasonably allocate labor costs between purchasing and non-purchasing activities.

(B) *Example.* The application of paragraph (c)(3)(ii)(A) of this section may be illustrated by the following example:

Example. Taxpayer O is a reseller that employs three persons, A, B, and C, who perform both purchasing and non-purchasing activities. These persons spend the following time performing purchasing activities: A-25%; B-70%; and C-50%. Under the 1/3-2/3 rule, Taxpayer O treats none of A's labor costs as purchasing costs, all of B's labor costs as

purchasing costs, and Taxpayer O allocates 50 % of C's labor costs as purchasing costs.

(4) *Handling costs*—(i) *In general.* Handling costs include costs attributable to processing, assembling, repackaging, transporting, and other similar activities with respect to property acquired for resale, provided the activities do not come within the meaning of the term produce as defined in §1.263A-2(a)(1). Handling costs are generally required to be capitalized under section 263A. Under this paragraph (c)(4)(i), however, handling costs incurred at a retail sales facility (as defined in paragraph (c)(5)(ii)(B) of this section) with respect to property sold to retail customers at the facility are not required to be capitalized. Thus, for example, handling costs incurred at a retail sales facility to unload, unpack, mark, and tag goods sold to retail customers at the facility are not required to be capitalized. In addition, handling costs incurred at a dual-function storage facility (as defined in paragraph (c)(5)(ii)(G) of this section) with respect to property sold to customers from the facility are not required to be capitalized to the extent that the costs are incurred with respect to property sold in on-site sales. Handling costs attributable to property sold to customers from a dual-function storage facility in on-site sales are determined by applying the ratio in paragraph (c)(5)(iii)(B) of this section.

(ii) *Processing costs.* Processing costs are the costs a reseller incurs in making minor changes or alterations to the nature or form of a product acquired for resale. Minor changes to a product include, for example, monogramming a sweater, altering a pair of pants, and other similar activities.

(iii) *Assembling costs.* Generally, assembling costs are costs associated with incidental activities that are necessary in readying property for resale (e.g., attaching wheels and handlebars to a bicycle acquired for resale).

(iv) *Repackaging costs.* Repackaging costs are the costs a taxpayer incurs to package property for sale to its customers.

(v) *Transportation costs.* Generally, transportation costs are the costs a taxpayer incurs moving or shipping property acquired for resale. These

costs include the cost of dispatching trucks; loading and unloading shipments; and sorting, tagging, and marking property. Transportation costs may consist of depreciation on trucks and equipment and the costs of fuel, insurance, labor, and similar costs. Generally, transportation costs required to be capitalized include costs incurred in transporting property—

(A) From the vendor to the taxpayer;

(B) From one of the taxpayer's storage facilities to another of its storage facilities;

(C) From the taxpayer's storage facility to its retail sales facility;

(D) From the taxpayer's retail sales facility to its storage facility; and

(E) From one of the taxpayer's retail sales facilities to another of its retail sales facilities.

(vi) *Costs not required to be capitalized as handling costs*—(A) *Distribution costs*—(1) *In general.* Distribution costs are not required to be capitalized. Distribution costs are any transportation costs incurred outside a storage facility in delivering goods to a customer. For this purpose, any costs incurred on a loading dock are treated as incurred outside a storage facility.

(2) *Costs incurred in transporting goods to a related person.* Distribution costs do not include costs incurred by a taxpayer in delivering goods to a related person. Thus, for example, when a taxpayer sells goods to a related person, the costs of transporting the goods are included in determining the basis of the goods that are sold, and hence in determining the resulting gain or loss from the sale, for all purposes of the Internal Revenue Code and the regulations thereunder. See, e.g., sections 267, 707, and 1502. For purposes of this provision, persons are related if they are described in section 267(b) or section 707(b).

(B) *Delivery of custom-ordered items.* Generally, costs incurred in transporting goods from a taxpayer's storage facility to its retail sales facility must be capitalized. However, costs incurred outside a storage facility in delivering custom-ordered items to a retail sales facility are not required to be capitalized. For this purpose, any costs incurred on a loading dock are treated as incurred outside a storage facility.

Delivery of custom-ordered items occurs when a taxpayer can demonstrate that a delivery to the taxpayer's retail sales facility is made to fill an identifiable order of a particular customer (placed by the customer before the delivery of the goods occurs) for the particular goods in question. Factors that may demonstrate the existence of a specific, identifiable delivery include the following—

(1) The customer has paid for the item in advance of the delivery;

(2) The customer has submitted a written order for the item;

(3) The item is not normally available at the retail sales facility for on-site customer purchases; and

(4) The item will be returned to the storage facility (and not held for sale at the retail sales facility) if the customer cancels an order.

(C) *Pick and pack costs*—(1) *In general.* Generally, handling costs incurred inside a storage or warehousing facility must be capitalized. However, costs attributable to pick and pack activities inside a storage or warehousing facility are not required to be capitalized. Pick and pack activities are activities undertaken in preparation for imminent shipment to a particular customer after the customer has ordered the specific goods in question. Examples of pick and pack activities include:

(i) Moving specific goods from a storage location in preparation for shipment to the customer;

(ii) Packing or repacking those goods for shipment to the customer; and

(iii) Staging those goods for shipment to the customer.

(2) *Activities that are not pick and pack activities.* Pick and pack activities do not include:

(i) Unloading goods that are received for storage;

(ii) Checking the quantity and quality of goods received;

(iii) Comparing the quantity of goods received to the amounts ordered and preparing the receiving documents;

(iv) Moving the goods to their storage location, e.g., bins, racks, containers, etc.; and

(v) Storing the goods.

(3) *Costs not attributable to pick and pack activities.* Occupancy costs, such as rent, depreciation, insurance, security,

taxes, utilities, and maintenance costs properly allocable to the storage or warehousing facility, are not costs attributable to pick and pack activities.

(5) *Storage costs*—(i) *In general.* Generally, storage costs are capitalized under section 263A to the extent they are attributable to the operation of an off-site storage or warehousing facility (an off-site storage facility). However, storage costs attributable to the operation of an on-site storage facility (as defined in paragraph (c)(5)(ii)(A) of this section) are not required to be capitalized under section 263A. Storage costs attributable to a dual-function storage facility (as defined in paragraph (c)(5)(ii)(G) of this section) must be capitalized to the extent that the facility's costs are allocable to off-site storage.

(ii) *Definitions*—(A) *On-site storage facility.* An on-site storage facility is defined as a storage or warehousing facility that is physically attached to, and an integral part of, a retail sales facility.

(B) *Retail sales facility.* (1) A retail sales facility is defined as a facility where a taxpayer sells merchandise exclusively to retail customers in on-site sales. For this purpose, a retail sales facility includes those portions of any specific retail site—

(i) Which are customarily associated with and are an integral part of the operations of that retail site;

(ii) Which are generally open each business day exclusively to retail customers;

(iii) On or in which retail customers normally and routinely shop to select specific items of merchandise; and

(iv) Which are adjacent to or in immediate proximity to other portions of the specific retail site.

(2) Thus, for example, two lots of an automobile dealership physically separated by an alley or an access road would generally be considered one retail sales facility, provided customers routinely shop on both of the lots to select the specific automobiles that they wish to acquire.

(C) *An integral part of a retail sales facility.* A storage facility is considered an integral part of a retail sales facility when the storage facility is an essential and indispensable part of the

retail sales facility. For example, if the storage facility is used exclusively for filling orders or completing sales at the retail sales facility, the storage facility is an integral part of the retail sales facility.

(D) *On-site sales.* On-site sales are defined as sales made to retail customers physically present at a facility. For example, mail order and catalog sales are made to customers not physically present at the facility, and thus, are not on-site sales.

(E) *Retail customer—(1) In general.* A retail customer is defined as the final purchaser of the merchandise. A retail customer does not include a person who resells the merchandise to others, such as a contractor or manufacturer that incorporates the merchandise into another product for sale to customers.

(2) *Certain non-retail customers treated as retail customers.* For purposes of this section, a non-retail customer is treated as a retail customer with respect to a particular facility if the following requirements are satisfied—

(i) The non-retail customer purchases goods under the same terms and conditions as are available to retail customers (e.g., no special discounts);

(ii) The non-retail customer purchases goods in the same manner as a retail customer (e.g., the non-retail customer may not place orders in advance and must come to the facility to examine and select goods);

(iii) Retail customers shop at the facility on a routine basis (i.e., on most business days), and no special days or hours are reserved for non-retail customers; and

(iv) More than 50 percent of the gross sales of the facility are made to retail customers.

(F) *Off-site storage facility.* An off-site storage facility is defined as a storage facility that is not an on-site storage facility.

(G) *Dual-function storage facility.* A dual-function storage facility is defined as a storage facility that serves as both an off-site storage facility and an on-site storage facility. For example, a dual-function storage facility would include a regional warehouse that serves the taxpayer's separate retail sales outlets and also contains a sales outlet therein. A dual-function

storage facility also includes any facility where sales are made to retail customers in on-site sales and to—

(1) Retail customers in sales that are not on-site sales; or

(2) Other customers.

(iii) *Treatment of storage costs incurred at a dual-function storage facility—(A) In general.* Storage costs associated with a dual-function storage facility must be allocated between the off-site storage function and the on-site storage function. To the extent that the dual-function storage facility's storage costs are allocable to the off-site storage function, they must be capitalized. To the extent that the dual-function storage facility's storage costs are allocable to the on-site storage function, they are not required to be capitalized.

(B) *Dual-function storage facility allocation ratio—(1) In general.* Storage costs associated with a dual-function storage facility must be allocated between the off-site storage function and the on-site storage function using the ratio of—

(i) Gross on-site sales of the facility (i.e., gross sales of the facility made to retail customers visiting the premises in person and purchasing merchandise stored therein); to

(ii) Total gross sales of the facility. For this purpose, the total gross sales of the facility include the value of items shipped to other facilities of the taxpayer.

(2) *Illustration of ratio allocation.* For example, if a dual-function storage facility's on-site sales are 40 percent of the total gross sales of the facility, then 40 percent of the facility's storage costs are allocable to the on-site storage function and are not required to be capitalized under section 263A.

(3) *Appropriate adjustments for other uses of a dual-function storage facility.* Prior to computing the allocation ratio in paragraph (c)(5)(iii)(B) of this section, a taxpayer must apply the principles of paragraph (c)(5)(iv) of this section in determining the portion of the facility that is a dual-function storage facility and the costs attributable to such portion).

(C) *De minimis 90-10 rule for dual-function storage facilities.* If 90 percent or

more of the costs of a facility are attributable to the on-site storage function, the entire storage facility is deemed to be an on-site storage facility. In contrast, if 10 percent or less of the costs of a storage facility are attributable to the on-site storage function, the entire storage facility is deemed to be an off-site storage facility.

(iv) *Costs not attributable to an off-site storage facility.* To the extent that costs incurred at an off-site storage facility are not properly allocable to the taxpayer's storage function, the costs are not accounted for as off-site storage costs. For example, if a taxpayer has an office attached to its off-site storage facility where work unrelated to the storage function is performed, such as a sales office, costs associated with this office are not off-site storage costs. However, if a taxpayer uses a portion of an off-site storage facility in a manner related to the storage function, for example, to store equipment or supplies that are not offered for sale to customers, costs associated with this portion of the facility are off-site storage costs.

(v) *Examples.* The provisions of this paragraph (c)(5) are illustrated by the following examples:

Example 1. Catalog or mail order center. Taxpayer P operates a mail order catalog business. As part of its business, P stores merchandise for shipment to customers who purchase the merchandise through orders placed by telephone or mail. P's storage facility is not an on-site storage facility because no on-site sales are made at the facility.

Example 2. Pooled-stock facility. Taxpayer Q maintains a pooled-stock facility, which functions as a back-up regional storage facility for Q's retail sales outlets in the nearby area. Q's pooled stock facility is an off-site

storage facility because it is neither physically attached to nor an integral part of a retail sales facility.

Example 3. Wholesale warehouse. Taxpayer R operates a wholesale warehouse where wholesale sales are made to customers physically present at the facility. R's customers resell the goods they purchase from R to final retail customers. Because no retail sales are conducted at the facility, all storage costs attributable to R's wholesale warehouse must be capitalized.

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

(2) *Eligible property.* Generally, the simplified resale method is only available to a trade or business exclusively engaged in resale activities. However, certain resellers with property produced as a result of de minimis production activities or property produced under contract may elect the simplified resale method, as described in paragraph (a)(4) of this section. Eligible property for purposes of the simplified resale method, therefore, includes any real or personal property described in section 1221(1) that is acquired for resale and any eligible property (within the meaning of § 1.263A-2(b)(2)) that is described in paragraph (a)(4) of this section.

(3) *Simplified resale method without historic absorption ratio election—(i) General allocation formula—(A) In general.* Under the simplified resale method, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year are computed as follows:

Combined absorption ratio \times section 471 costs remaining on hand at year end

(B) *Effect of allocation.* The resulting product under the general allocation formula 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.

(C) *Definitions—(1) Combined absorption ratio.* The combined absorption ratio is defined as the sum of the storage and handling costs absorption ratio as defined in paragraph (d)(3)(i)(D) of this section and the purchasing costs absorption ratio as defined in paragraph (d)(3)(i)(E) of this section.

(2) *Section 471 costs remaining on hand at year end.* Section 471 costs remaining on hand at year end mean the section 471 costs, as defined in §1.263A-1(d)(2), that the 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 (d)(3)(ii) of this section for special rules applicable to LIFO tax-

payers. Except as otherwise provided in this section or in §1.263A-1 or 1.263A-2, additional section 263A costs that are allocated to inventories on hand at the close of the taxable year under the simplified resale method of this paragraph (d) are treated as inventory costs for all purposes of the Internal Revenue Code.

(D) *Storage and handling costs absorption ratio.* (1) Under the simplified resale method, the storage and handling costs absorption ratio is determined as follows:

$$\frac{\text{Current year's storage and handling costs}}{\text{Beginning inventory plus current year's purchases}}$$

(2) Current year's storage and handling costs are defined as the total storage costs plus the total handling costs incurred during the taxable year that relate to the taxpayer's property acquired for resale and other eligible property. See paragraph (c) of this section, which discusses storage and handling costs. Storage and handling costs must include the amount of allocable mixed service costs as described in paragraph (d)(3)(i)(F) of this section. Beginning inventory in the denominator of the storage and handling costs absorption ratio refers to the section 471 costs of any property acquired for resale or other eligible property held

by the taxpayer as of the beginning of the taxable year. Current year's purchases generally mean the taxpayer's section 471 costs incurred with respect to purchases of property acquired for resale during the current taxable year. In computing the denominator of the storage and handling costs absorption ratio, a taxpayer using a dollar-value LIFO method of accounting, must state beginning inventory amounts using the LIFO carrying value of the inventory and not current-year dollars.

(E) *Purchasing costs absorption ratio.* (1) Under the simplified resale method, the purchasing costs absorption ratio is determined as follows:

$$\frac{\text{Current year's purchasing costs}}{\text{Current year's purchases}}$$

(2) Current year's purchasing costs are defined as the total purchasing costs incurred during the taxable year that relate to the taxpayer's property acquired for resale and eligible property. See paragraph (c)(3) of this section, which discusses purchasing costs. Purchasing costs must include the amount of allocable mixed service costs determined in paragraph (d)(3)(i)(F) of this section. Current year's purchases generally mean the taxpayer's section 471 costs incurred

with respect to purchases of property acquired for resale during the current taxable year.

(F) *Allocable mixed service costs.* (1) If a taxpayer allocates its mixed service costs to purchasing costs, storage costs, and handling costs using a method described in §1.263A-1(g)(4), the taxpayer is not required to determine its allocable mixed service costs under this paragraph (d)(3)(i)(F). However, if the taxpayer uses the simplified service cost method, the amount of mixed

service costs allocated to and included in purchasing costs, storage costs, and handling costs in the absorption ratios

in paragraphs (d)(3)(i) (D) and (E) of this section is determined as follows:

$$\frac{\text{Labor costs allocable to activity}}{\text{Total labor costs}} \times \text{Total mixed service costs}$$

(2) Labor costs allocable to activity are defined as the total labor costs allocable to each particular activity (i.e., purchasing, handling, and storage), excluding labor costs included in mixed service costs. Total labor costs are defined as the total labor costs (excluding labor costs included in mixed service costs) that are incurred in the taxpayer's trade or business during the taxable year. See § 1.263A-1(h)(6) for the definition of total mixed service costs.

(i) *LIFO taxpayers electing simplified resale method*—(A) *In general.* Under the simplified resale method, a taxpayer using a LIFO method must calculate a particular year's index (e.g., under § 1.472-8(e)) without regard 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 combined 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 sec-

tion 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.

(iii) *Permissible variations of the simplified resale method.* The following variations of the simplified resale method are permitted:

(A) The exclusion of beginning inventories from the denominator in the storage and handling costs absorption ratio formula in paragraph (d)(3)(i)(D) of this section; or

(B) Multiplication of the storage and handling costs absorption ratio in paragraph (d)(3)(i)(D) of this section by the total of section 471 costs included in a LIFO taxpayer's ending inventory (rather than just the increment, if any, experienced by the LIFO taxpayer during the taxable year) for purposes of determining capitalizable storage and handling costs.

(iv) *Examples.* The provisions of this paragraph (d)(3) are illustrated by the following examples:

Example 1. FIFO inventory method. (i) Taxpayer S uses the FIFO method of accounting for inventories. S's beginning inventory for 1994 (all of which was sold during 1994) was \$2,100,000 (consisting of \$2,000,000 of section 471 costs and \$100,000 of additional section 263A costs). During 1994, S makes purchases of \$10,000,000. In addition, S incurs purchasing costs of \$460,000, storage costs of \$110,000, and handling costs of \$90,000. S's purchases (section 471 costs) remaining in ending inventory at the end of 1994 are \$3,000,000.

(ii) In 1994, S incurs \$400,000 of total mixed service costs and \$1,000,000 of total labor costs (excluding labor costs included in mixed service costs). In addition, S incurs the following labor costs (excluding labor

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costs included in mixed service costs): purchasing—\$100,000, storage—\$200,000, and handling—\$200,000. Accordingly, the following mixed service costs must be included in purchasing costs, storage costs, and handling costs as capitalizable mixed service costs: purchasing—\$40,000 ([\$100,000 divided by

\$1,000,000] multiplied by \$400,000); storage—\$80,000 ([\$200,000 divided by \$1,000,000] multiplied by \$400,000); and handling—\$80,000 ([\$200,000 divided by \$1,000,000] multiplied by \$400,000).

(iii) S computes its purchasing costs absorption ratio for 1994 as follows:

$$\begin{aligned} \frac{\text{1994 purchasing costs}}{\text{1994 purchases}} &= \frac{\$460,000 + \$40,000}{\$10,000,000} \\ &= \frac{\$500,000}{\$10,000,000} \\ &= 5.0\% \end{aligned}$$

(iv) S computes its storage and handling costs absorption ratio for 1994 as follows:

$$\begin{aligned} \frac{\text{Storage and handling costs}}{\text{Beginning inventory plus 1994 purchases}} &= \frac{(\$110,000 + \$80,000) + (\$90,000 + \$80,000)}{\$2,000,000 + \$10,000,000} \\ &= \frac{\$190,000 + \$170,000}{\$12,000,000} \\ &= \frac{\$360,000}{\$12,000,000} \\ &= 3.0\% \end{aligned}$$

(v) S's combined absorption ratio is 8.0 %, or the sum of the purchasing costs absorption ratio (5.0 %) and the storage and handling costs absorption ratio (3.0 %). Under the simplified resale method, S determines

the additional section 263A costs allocable to its ending inventory by multiplying the combined absorption ratio by its section 471 costs with respect to current year's purchases remaining in ending inventory:

$$\text{Additional section 263A costs} = 8.0\% \times \$3,000,000 = \$240,000$$

(vi) S adds this \$240,000 to the \$3,000,000 of purchases remaining in its ending inventory to determine its total ending FIFO inventory of \$3,240,000.

Example 2. LIFO inventory method. (i) Taxpayer T uses a dollar-value LIFO inventory method. T's beginning inventory for 1994 is \$2,100,000 (consisting of \$2,000,000 of section 471 costs and \$100,000 of additional section 263A costs). During 1994, T makes purchases

of \$10,000,000. In addition, T incurs purchasing costs of \$460,000, storage costs of \$110,000, and handling costs of \$90,000. T'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) In 1994, T incurs \$400,000 of total mixed service costs and \$1,000,000 of total labor costs (excluding labor costs included in

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mixed service costs). In addition, T incurs the following labor costs (excluding labor costs included in mixed service costs): purchasing—\$100,000, storage—\$200,000, and handling—\$200,000. Accordingly, the following mixed service costs must be included in purchasing costs, storage costs, and handling costs as capitalizable mixed service costs: purchasing—\$40,000 ([\$100,000 divided by \$1,000,000] multiplied by \$400,000); storage—\$80,000 ([\$200,000 divided by \$1,000,000] multiplied by \$400,000); and handling—\$80,000 ([\$200,000 divided by \$1,000,000] multiplied by \$400,000).

(iii) Based on these facts, T determines that it has a combined absorption ratio of 8.0 %. To determine the additional section 263A costs allocable to its ending inventory, T multiplies its combined absorption ratio (8.0 %) by the \$1,000,000 LIFO increment. Thus, T's additional section 263A costs allocable to its ending inventory are \$80,000 (\$1,000,000 multiplied by 8.0 %). This \$80,000 is added to the \$1,000,000 to determine a total 1994 LIFO increment of \$1,080,000. T's ending inventory is \$3,180,000 (its beginning inventory of \$2,100,000 plus the \$1,080,000 increment).

(iv) In 1995, T sells one-half of the inventory in its 1994 LIFO increment. T must include in its cost of goods sold for 1995 the amount of additional section 263A costs relating to this inventory, i.e., one-half of the \$80,000 additional section 263A costs capitalized in 1994 ending inventory, or \$40,000.

Example 3. LIFO Pools. (i) Taxpayer U begins its business in 1994, and adopts the LIFO inventory method. During 1994, U makes purchases of \$10,000, and incurs \$400 of purchasing costs, \$350 of storage costs and \$250 of handling costs. U's purchasing costs, storage costs, and handling costs include their proper allocable share of mixed service costs.

(ii) U computes its purchasing costs absorption ratio for 1994, as follows:

$$\frac{1994 \text{ purchasing costs}}{1994 \text{ purchases}} = \frac{\$400}{\$10,000} = 4.0\%$$

(iii) U computes its storage and handling costs absorption ratio for 1994, as follows:

$$\frac{1994 \text{ storage and handling costs}}{\text{Beginning inventory plus 1994 purchases}} = \frac{\$350 + \$250}{\$0 + \$10,000} = \frac{\$600}{\$10,000} = 6.0\%$$

(iv) U's combined absorption ratio is 10%, or the sum of the purchasing costs absorption ratio (4.0%) and the storage and handling costs absorption ratio (6.0%). At the end of 1994, U's ending inventory included

\$3,000 of current year purchases, contained in three LIFO pools (X, Y, and Z) as shown below. Under the simplified resale method, U computes its ending inventory for 1994 as follows:

1994	Total	X	Y	Z
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

(v) During 1995, U makes purchases of \$2,000 as shown below, and incurs \$200 of purchasing costs, \$325 of storage costs and \$175 of handling costs. U's purchasing costs, storage costs, and handling costs include their proper share of mixed service costs. Moreover, U sold goods from pools X, Y, and Z

having a total cost of \$1,000. U computes its ending inventory for 1995 as follows.

(vi) U computes its purchasing costs absorption ratio for 1995:

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$$\frac{1995 \text{ purchasing costs}}{1995 \text{ purchases}} = \frac{\$200}{\$2,000} = 10.0\%$$

(vii) U computes its storage and handling costs absorption ratio for 1995:

$$\frac{1995 \text{ storage and handling costs}}{\text{Beginning inventory plus 1995 purchases}} = \frac{\$325 + \$175}{\$3,000 + \$2,000} = \frac{\$500}{\$5,000} = 10.0\%$$

(viii) U's combined absorption ratio is 20.0%, or the sum of the purchasing costs absorption ratio (10.0%) and the storage and handling costs absorption ratio (10.0%).

1995	Total	X	Y	Z
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		
Additional section 263A costs:	4,000	2,800	600	600
1994 (10%)	280	160	60	60
1995 (20%)	240	240		
1995 ending inventory	520	400	60	60
	4,520	3,200	660	660

(ix) In 1995, U experiences a \$200 decrement in Pool Z. Thus, U 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, U determines a ratio by dividing the decrement by the section 471 costs in the 1994 layer (\$200 divided by \$800, or 25%). U 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 U in 1995 as part of its cost of goods sold (\$80 multiplied by 25%).

(4) *Simplified resale method with historic absorption ratio election*—(i) *In general.* This paragraph (d)(4) permits resellers using the simplified resale 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 (d)(4)(v) of this section, a

taxpayer may only make a historic absorption ratio election if it has used the simplified resale method for three or more consecutive taxable years immediately prior to the year of election. The historic absorption ratio is used in lieu of an actual combined absorption ratio computed under paragraph (d)(3)(i)(C)(I) 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 the qualifying period described in paragraph (d)(4)(ii)(C) of this section.

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

Additional section 263A costs incurred during the test period

Section 471 costs incurred during the test period

(2) Additional section 263A costs incurred during the test period are defined as the sum of the products of the combined absorption ratios (defined in paragraph (d)(3)(i)(C)(1) of this section) multiplied by a taxpayer's section 471 costs incurred with respect to purchases, for each taxable year of the test period.

(3) Section 471 costs incurred during the test period mean the section 471 costs described in § 1.263A-1(d)(2) that a taxpayer incurs generally with respect to its purchases during the test period described in paragraph (d)(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 (as defined in paragraph (d)(4)(ii)(C) of this section). 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.

(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 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 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 (i.e., the previous five taxable years), the qualifying period must be 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 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.

(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 resale method may elect the historic absorption ratio in any taxable year if permitted under this paragraph (d)(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 resale method in determining its section 263A costs. Accordingly, in computing its actual combined 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 (d)(4)(iii)(A), the recomputation of the historic absorption ratio during an updated test period and the change from a historic absorption ratio to an actual combined absorption ratio during an updated test period by reason of the requirements of this paragraph (d)(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 (d)(4) must attach a statement to its federal income tax return for the taxable year in which the election is made showing the actual combined absorption ratios determined under the simplified resale 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 resale 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-2 had applied throughout the test period.

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

Example. (i) Taxpayer V uses the FIFO method of accounting for inventories and in 1994 elects to use the historic absorption ratio with the simplified resale method. After recomputing its additional section 263A costs in accordance with the transition rules of paragraph (d)(4)(v) of this section, V 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, V 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, V incurs \$10,000 of section 471 costs of which \$3,000 remain in inventory at the end of the year. Under the simplified resale method using a historic absorption ratio, V determines the additional section

263A costs allocable to its ending inventory by multiplying its historic ratio (5%) by the section 471 costs remaining in its ending inventory:

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

(iv) To determine its ending inventory under section 263A, V 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 V's additional section 263A costs incurred during 1994 is taken into account in 1994 as part of V's cost of goods sold.

(v) V's qualifying period ends as of the close of its 1998 taxable year. Therefore, 1999 is a recomputation year in which V must compute its actual combined absorption ratio. V determines its actual absorption ratio for 1999 to be 5.25% and compares that ratio to its historic absorption ratio (5.0%). Therefore, V 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, V's actual combined absorption ratio for 1999 were not between 4.5% and 5.5%, V's qualifying period would end and V would be required to compute a new historic absorption ratio with reference to an updated test period of 1999, 2000, and 2001. Once V's historic absorption ratio is determined for the updated test period, it would be used for a new qualifying period beginning in 2002.

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

(e) *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.

[T.D. 8482, 58 FR 42224, Aug. 9, 1993; 58 FR 47784, Sept. 10, 1993; 59 FR 3319, Jan. 21, 1994, as amended by T.D. 8559, 59 FR 39962, Aug. 5, 1994]

§ 1.263A-4 Rules for property produced in a farming business.

(a) *Introduction*—(1) *In general.* This section provides guidance with respect to the application of section 263A to property produced in a farming business as defined in paragraph (a)(4) of this section. Except as otherwise provided by the rules of this section, the general rules of §§ 1.263A-1 through 1.263A-3 and §§ 1.263A-7 through 1.263A-15 apply to property produced in a farming business. A taxpayer that engages in the raising or growing of any agricultural or horticultural commodity, including both plants and animals, is engaged in the production of

property. Section 263A generally requires the capitalization of the direct costs and an allocable portion of the indirect costs that directly benefit or are incurred by reason of the production of this property. The direct and indirect costs of producing plants or animals generally include preparatory costs allocable to the plant or animal and preproductive period costs of the plant or animal. Except as provided in paragraphs (a)(2) and (e) of this section, taxpayers must capitalize the costs of producing all plants and animals unless the election described in paragraph (d) of this section is made.

(2) *Exception*—(i) *In general.* Section 263A does not apply to the costs of producing plants with a preproductive period of 2 years or less or the costs of producing animals in a farming business, if the taxpayer is not—

(A) A corporation or partnership required to use an accrual method of accounting (accrual method) under section 447 in computing its taxable income from farming; or

(B) A tax shelter prohibited from using the cash receipts and disbursements method of accounting (cash method) under section 448(a)(3).

(ii) *Tax shelter*—(A) *In general.* A farming business is considered a tax shelter, and thus a taxpayer prohibited from using the cash method under section 448(a)(3), if the farming business is—

(1) A farming syndicate as defined in section 464(c); or

(2) A tax shelter, within the meaning of section 6662(d)(2)(C)(iii).

(B) *Presumption.* Marketed arrangements in which persons carry on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance, within the meaning of section 6662(d)(2)(C)(iii), if such persons prepay a substantial portion of their farming expenses with borrowed funds.

(iii) *Examples.* The following examples illustrate the provisions of this paragraph (a)(2):

Example 1. Farmer A grows trees that have a preproductive period in excess of 2 years, and that produce an annual crop. Farmer A is not required by section 447 to use an accrual method or prohibited by section