INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-104201-04, CC:ITA:B06

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

ISSUES:

(1) Under the circumstances described below, whether Taxpayer's construction of prehung doors constitutes the production of tangible personal property within the meaning of § 263A(g)(1) of the Internal Revenue Code and §§ 1.263A-2(a)(1) and 1.263A-2(a)(2) of the Income Tax Regulations, and therefore Taxpayer is a reseller with production activities within the meaning of § 1.263A-3(a)(2).

(2) If the answer to Issue (1) is "yes," whether Taxpayer's production activities are de minimis within the meaning of § 1.263A-3(a)(2)(iii).

(3) If the answer to Issue (1) is "yes" and the answer to Issue (2) is "no," whether the Commissioner may require Taxpayer to use using any method that in his opinion clearly reflects the taxpayer's taxable income.

CONCLUSIONS:

(1) Under the circumstances described below, Taxpayer's construction of prehung doors constitutes the production of tangible personal property within the meaning of § 263A(g)(1) of the Internal Revenue Code and §§ 1.263A-2(a)(1) and 1.263A-2(a)(2) of the Income Tax Regulations, and therefore Taxpayer is a reseller with production activities within the meaning of § 1.263A-3(a)(2).

(2) Taxpayer's production activities are not de minimis within the meaning of § 1.263A-3(a)(2)(iii).

(3) The Service may require Taxpayer to use any method that in his opinion clearly reflects the taxpayer's taxable income.

FACTS:

Taxpayer sells pre-hung doors as well as various building materials for homes. All products purchased by Taxpayer are sold as is except for the pre-hung doors. The assembled pre-hung door sales are more than thirty percent of the company's total sales.

Taxpayer does not install the pre-hung doors in the homes, but puts the door together with the door frame per customer specifications. The activities associated with the construction of exterior pre-hung doors include stapling the door frame together, routing for hinges, and screwing the hinges on the door. This process typically takes 4 employees approximately 15 minutes. The assembly of interior pre-hung doors uses specialized equipment. The interior door is loaded into the machine which cuts the casing, the hinges are installed, and the frame is built. The interior pre-hung door takes approximately 10 minutes.

Taxpayer constructs pre-hung doors only when an order is placed. The pre-hung doors are assembled within one day of the customer's order and shipped the same day or the next business day. Taxpayer has historically deducted the costs as they were incurred.

Taxpayer's average annual gross receipts for the three previous taxable years did not exceed $10 million. Taxpayer's gross receipts from sale of the produced property represent more than thirty percent of Taxpayer's total sales. The Service and Taxpayer disagree on the portion of Taxpayer's total labor costs attributable to the direct labor involved in construction of pre-hung doors, but both parties agree that it is more than fourteen percent of Taxpayer's total labor costs.

APPLICABLE LAW:

Generally, § 263A provides that certain direct and indirect costs, for property held as inventory, must be included in the cost of inventory, or in the case of other property, must be capitalized.

Section 263A(b)(1) provides that § 263A applies to real or tangible personal property produced by the taxpayer. Section 263A(b)(2)(A) provides that § 263A applies to real or personal property described in § 1221(a)(1) that is acquired for resale. Section 263A(b)(2)(B) provides an exception to the requirement to capitalize costs under § 263A for property acquired for resale if the taxpayer has average annual gross receipts for the three preceding years of $10 million or less.

Section 263A(g)(1) provides, in general, that the term "produce" includes construct, build, install, manufacture, develop, or improve. Section 1.263A-2(a)(1) provides that the term "produce," for purposes of § 263A, includes the following: construct, build, install, manufacture, develop, improve, create, raise, or grow.

Section 1.263A-1(c)(1) provides that under § 263A, taxpayers must capitalize their direct costs and a properly allocable share of their indirect costs to property produced or property acquired for resale. In order to determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production or resale activities. After § 263A costs are allocated to the appropriate production or resale activities, these costs are generally allocated to the items of property produced or acquired for resale during the taxable year and capitalized to the items that remain on hand at the end of the taxable year.

Generally, § 1.263A-3(a)(2)(i) provides that a taxpayer must capitalize all direct costs and certain indirect costs associated with real property and tangible personal property it produces. Except as otherwise provided, a reseller, including a small reseller, that also produces property, must capitalize the additional § 263A costs associated with any property it produces.

Section 1.263A-3(c)(4)(i) provides, in general, that 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).

Section 1.263A-3(c)(4)(ii) provides that 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. Section 1.263A-3(c)(4)(iii) provides that assembling costs generally are associated with incidental activities that are necessary in readying property for resale, such as attaching wheels and handlebars to a bicycle acquired for resale.

Section 1.263A-3(a)(2)(ii) provides an exception for small resellers. Specifically, a small reseller is not required to capitalize additional § 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 § 1.263A-3(a)(2)(iii)).

Section 1.263A-3(a)(2)(iii)(A)(1) provides 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 to be 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 production activities of the trade or business are less than 10 percent of the reseller's total labor costs.

Section 1.263A-2(b)(1) provides a simplified method for determining the additional § 263A costs properly allocable to ending inventories of property produced and other eligible property on hand at the end of the taxable year.

Section 1.263A-1(f)(1) provides that taxpayers may use the simplified methods provided in §§ 1.263A-2(b) and 1.263A-3(d) to allocate direct and indirect costs to eligible property produced or eligible property acquired for resale.

Section 1.263A-1(f)(4) provides that a taxpayer may use the methods described in the regulations if they are reasonable allocation methods and that a taxpayer may use any other reasonable method to properly allocate direct and indirect costs. An allocation method is considered reasonable if:

(i) the total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in §§ 1.263A-1(f), 1.263A-2, or 1.263A-3, with appropriate consideration given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, the time and cost of using various allocation methods, and the accuracy of the allocation method chosen as compared with other allocations;
(ii) the allocation method is applied consistently by the taxpayer; and
(iii) the allocation method is not used to circumvent the requirements of the simplified methods provided in §§ 1.263A-1(f), 1.263A-2, 1.263A-3, or the principles of § 263A.

Section 1.263A-2(b)(2) provides that (except for self constructed assets taxpayer elects to exclude) 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 inventory property.

Section 446(b) provides that if the method of accounting used by the taxpayer does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Commissioner, does clearly reflect income. *See also* § 1.446-1(a)(2).

ANALYSIS:

(1) Under the circumstances described above, whether Taxpayer's assembly activity constitutes the production of tangible personal property within the meaning of § 263A(g)(1) of the Internal Revenue Code and §§ 1.263A-2(a)(1) and 1.263A-2(a)(2) of the Income Tax Regulations, and therefore Taxpayer is a reseller with production activity within the meaning of § 1.263A-3(a)(2).

Taxpayer is a reseller engaged in the sale of doors and other products to home builders. Taxpayer's average annual gross receipts for the three previous taxable years did not exceed $10 million. Consequently, under § 263A(b)(2)(B), Taxpayer qualifies as a "small reseller," and is not required to capitalize costs under § 263A to property acquired for resale. However, this exception does not apply to property produced by Taxpayer. If Taxpayer's assembly of pre-hung doors constitutes "production," it must capitalize the required § 263A costs, unless the de minimis exception (discussed in (2), below) applies.

For purposes of the uniform capitalization rules, "produce" includes construct, build, install, manufacture, develop, improve, create, raise, or grow. Whether Taxpayer's activities in constructing pre-hung doors constitute production depends on the specific facts. Taxpayer's assembly process includes stapling the door frame, routing for hinges, screwing the hinges on the doors, and for interior pre-hung doors the process also includes using specialized equipment to cut the casing. The constructing of each door requires the labor of several employees.

If these assembly activities simply fell under the definition of "handling costs" under § 1.263A-3(c)(4), they would not be considered production. Section 1.263A-3(c)(4) provides that certain handling costs, including processing and assembling costs, do not come within the meaning of produce under § 263A. Section 1.263A-3(c)(4)(ii) provides that 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, including, for example, monogramming a sweater, altering a pair of pants, and other similar activities. Section 1.263A-3(c)(4)(iii) provides that assembling costs generally are associated with incidental activities that are necessary in readying property for resale, such as attaching wheels and handlebars to a bicycle acquired for resale.

Taxpayer is constructing pre-hung doors. The cutting of the casing, building of the frame, routing, and installation of hinges to fit the door to the frame are not incidental activities. Unlike hemming a pair of pants, these are significant modifications to the property. The equipment and labor used in this process add costs to the property and transform it into a pre-hung door. More than fourteen percent of Taxpayer's total labor costs are attributable to the direct labor involved in assembly of pre-hung doors.

Taxpayer's pre-hung door activities are thus production activities since they improve and add value to the product and transform it into a new product for sale. Consequently, Taxpayer is a reseller with production activity within the meaning of § 1.263A-3(a)(2).

(2) If the answer to Issue (1) is "yes," whether Taxpayer's production activities are de minimis within the meaning of § 1.263A-3(a)(2)(iii).

Even though Taxpayer produces pre-hung doors, § 1.263A-3(a)(2)(ii) exempts a small reseller from capitalizing additional § 263A costs associated with its production activities if the production activities are de minimis.

Under § 1.263A-3(a)(2)(iii), Taxpayer's production activities are presumed to be de minimis if the sales of the produced property are less than ten percent of total sales, and the labor costs allocable to the production activities are less than ten percent of total labor costs.

Taxpayer's gross receipts from sale of the produced property represent more than thirty percent of Taxpayer's total sales. Since both sales and labor costs are required to be under the ten percent limit for the production activities to be presumed de minimis, Taxpayer's sales alone would eliminate such a presumption for Taxpayer. In addition, Taxpayer's labor costs do not fall below the ten percent threshold. Since Taxpayer meets neither the sales nor the labor cost limits, its production activities do not qualify as de minimis under § 1.263A-3(a)(2)(iii).

While Taxpayer fails the percentage test, its activities may still be considered de minimis based on a consideration of all of the facts and circumstances of the case. Taxpayer concedes that its labor costs do not meet the ten percent limit under § 1.263A-3(a)(2)(iii). Taxpayer argues that its automated machinery and standardized procedures result in minimal actual labor in assembling pre-hung doors. However, the use of automated machinery in the production process weighs against treating the production activity as de minimis, as such machinery is more in line with traditional production activities.

Taxpayer also argues that its production activity is de minimis because the amount of additional § 263A costs it calculates would be allocated to ending inventory is trivial relative to overall cost of goods sold. However, the issue is not whether the additional § 263A costs are de minimis, but whether the production activities themselves are de minimis. Where the sales of produced property are more than thirty percent of a taxpayer's total sales, such production activities are not de minimis.

Given the material amount of Taxpayer's sales and labor costs attributable to the production activities, Taxpayer's production activities are not de minimis within the meaning of § 1.263A-3(a)(2)(iii).

(3) If the answer to Issue (1) is "yes" and the answer to Issue (2) is "no," whether the Commissioner may require Taxpayer to use any method that in his opinion clearly reflects the taxpayer's taxable income.

Section 446(b) provides that if the taxpayer's method of accounting does not clearly reflect income, the computation of taxable income shall be made under such method as, in the Commissioner's opinion, does clearly reflect income. *See also* § 1.446-1(a)(2).

The Commissioner "has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income." *Commissioner v. Hansen*, 360 U.S. 446, 467 (1959), 1959-2 C.B. 460.

> Once the Commissioner determines that a taxpayer's method does not clearly reflect income, he may select for the taxpayer a method which, in his opinion, does clearly reflect income. Sec. 446(b). The taxpayer carries the burden of showing that the method selected by the Commissioner is incorrect, and such burden is extremely difficult to carry.

Hamilton Industries, Inc. v. Commissioner, 97 T.C. 120, 129 (1991) (citing *Photo-Sonics, Inc. v. Commissioner*, 42 T.C. 926, 933 (1964), *affd*. 357 F.2d 656 (9th Cir. 1966)).

> Section 446 vests the Commissioner with wide discretion in determining whether a particular method of accounting clearly reflects income, and a heavy burden is imposed upon the taxpayer to overcome a determination by the Commissioner in this area.

Rotolo v. Commissioner, 88 T.C. 1500, 1513-1514 (1987).

The courts have consistently held that the Commissioner's authority under section 446(b) permits him to select the method of accounting the taxpayer must use once he has determined that a taxpayer's method does not clearly reflect income. *See Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), 1979-1 C.B. 167; *Ford Motor Company v. Commissioner*, 71 F.3d 209 (6th Cir. 1995); *Mulholland v. U.S.*, 28 Fed.Cl. 320, 335 (1993), *aff'd without op.*, 22 F.3d 1105 (Fed. Cir. 1994).

Accordingly, we conclude that the Commissioner may compute the taxpayer's taxable income using any method that in his opinion clearly reflects the taxpayer's taxable income.

CAVEAT(S):

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