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memorandum**

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subject: Classification of an engineering department that supports production activities and incurs § 174 research and experimental expenditures as a mixed service department.

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

ISSUE

Whether an engineering department that incurs service costs allocable to production activities and also incurs research and experimental expenditures as defined in IRC § 174 and the regulations thereunder constitutes a mixed service department.

CONCLUSION

The engineering department constitutes a mixed service department because the § 174 research and experimental expenditures are allocable to non-production or non-resale activities.

FACTS

Taxpayer is an investor-owned utility that produces, transmits, distributes, and sells electric energy. Taxpayer has two types of production activities: (1) the production of electricity and (2) the production of self-constructed assets (SCA). Taxpayer uses an overall accrual method of accounting.

Taxpayer's present method of accounting for determining capitalizable mixed service costs for allocation between production activities (the production of electricity and SCA) and non-production activities is the simplified service cost method.

Taxpayer analyzed its service departments and determined that some of the departments incurred only capitalizable service costs, and the costs of those departments were capitalized to production activities. Similarly, Taxpayer determined that some service departments incurred only deductible service costs, and the costs of those departments were deducted. Finally, Taxpayer determined that some of its service departments were mixed service departments, and the costs of those departments were allocated among its various production and non-production activities.

Taxpayer treated an engineering department that incurred service costs allocable to production activities as a mixed service department when the department also incurred research and experimental expenditures as defined in IRC § 174 and the regulations thereunder.

Taxpayer has not elected the 90-10 de minimis rule of § 1.263A-1(g)(4)(ii), whereby if 90 percent or more of a mixed service department's costs are capitalizable service costs, the taxpayer must allocate 100 percent of the department's costs to the production or resale activity benefitted. Further, this memorandum assumes that the engineering department that is the subject of this advice constitutes a service department as defined in § 1.263A-1(e)(4)(i)(B), and accordingly that the costs incurred by the department are service costs as defined in § 1.263A-1(e)(4)(i)(A).

LAW AND ANALYSIS

Sections 263A(a) and (b) provide that the direct costs and indirect costs properly allocable to property produced or property acquired for resale by the taxpayer shall be capitalized to such property.

Section 263A(c)(2) provides that § 263A shall not apply to any amount allowable as a deduction under § 174.

Section 1.263A-1(a)(3)(ii) provides that taxpayers that produce real property and tangible personal property (producers) must capitalize all the direct costs of producing the property and the property's properly allocable share of indirect costs, regardless of whether the property is sold or used in the taxpayer's trade or business.

Section 1.263A-1(c)(1) provides that 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.

Section 1.263A-1(c)(2) provides that a cost is not taken into account under § 263A (i) to the extent the cost (but for § 263A and the regulations thereunder) may not be taken into account in computing taxable income for any taxable year, and (ii) any earlier than the taxable year during which the cost is incurred within the meaning of § 1.446-1(c)(1)(ii).

Section 1.263A-1(e)(3)(i) provides that indirect costs are defined as all costs other than direct materials and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). Taxpayers subject to § 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale.

Section 1.263A-1(e)(3)(i) also provides that indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities. Further, § 1.263A-1(e)(3)(i) provides that indirect costs may be allocable to both production and resale activities, as well as to other activities that are not subject to § 263A. Taxpayers subject to § 263A must make a reasonable allocation of indirect costs between production, resale, and other activities.

Section 1.263A-1(e)(3)(ii)(P) provides that engineering and design costs, to the extent they are properly allocable to property produced or property acquired for resale, are an example of an indirect cost that must be capitalized. Engineering and design costs include pre-production costs, such as costs attributable to research, experimental, engineering and design activities (to the extent that such amounts are not research and experimental expenditures as described in § 174 and the regulations thereunder).

Section 1.263A-1(e)(3)(iii) lists indirect costs that are not required to be capitalized under § 263A, including:

- (A) Selling and distribution costs. These costs are marketing, selling, advertising, and distribution costs.
- (B) Research and experimental expenditures. Research and experimental expenditures are expenditures described in § 174 and the regulations thereunder.
- (C) Section 179 costs. Section 179 costs are expenses for certain depreciable assets deductible at the election of the taxpayer under § 179 and the regulations thereunder.

(D) Section 165 losses. Section 165 losses are losses under § 165 and the regulations thereunder.

(K) Deductible service costs. Service costs that are not required to be capitalized include deductible service costs and deductible mixed service costs as defined in § 1.263A-1(e)(4).

Section 1.263A-1(e)(4)(i)(A) provides that service costs are defined as a type of indirect costs (e.g., general and administrative costs) that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function.

Section 1.263A-1(e)(4)(i)(B) provides that service departments are defined as administrative, service, or support departments that incur service costs. The facts and circumstances of the taxpayer's activities and business organization control whether a department is a service department. For example, service departments include personnel, accounting, data processing, security, legal, and other similar departments.

Section 1.263A-1(e)(4)(ii)(A) provides that capitalizable service costs are defined as service costs that directly benefit or are incurred by reason of the performance of the production or resale activities of the taxpayer. Therefore, these service costs are required to be capitalized under § 263A.

Section 1.263A-1(e)(4)(ii)(B) provides that deductible service costs are defined as service costs that do not directly benefit or are not incurred by reason of the performance of the production or resale activities of the taxpayer, and therefore, are not required to be capitalized under § 263A. Deductible service costs generally include costs incurred by reason of the taxpayer's overall management or policy guidance functions. In addition, deductible service costs include costs incurred by reason of the marketing, selling, advertising, and distribution activities of the taxpayer.

Section 1.263A-1(e)(4)(ii)(C) provides that mixed service costs are defined as service costs that are partially allocable to production or resale activities (capitalizable mixed service costs) and partially allocable to non-production or non-resale activities (deductible mixed service costs). For example, a personnel department may incur costs to recruit factory workers, the costs of which are allocable to production activities, and it may incur costs to develop wage, salary, and benefit policies, the costs of which are allocable to non-production activities.

The engineering department that is the subject of this advice performs engineering and design activities exclusively related to the taxpayer's electricity generation activities. Some, but not all, of the engineering and design costs qualify as research and experimental expenditures under § 174. Thus, some of the engineering department's costs are capitalizable engineering and design costs under § 263A and some of the costs are deductible research and experimental expenditures under § 174. For purposes of this advice, we are assuming that the engineering and design costs are

service costs. The issue in this case is whether the engineering department is a mixed service department.

A service department must incur mixed service costs in order to be classified as a mixed service department. Under § 1.263A-1(e)(4)(ii)(C), mixed service costs are service costs that are partially allocable to production or resale activities (capitalizable mixed service costs) and partially allocable to non-production or non-resale activities (deductible mixed service costs). Given that the engineering department has incurred service costs related to production activities and § 174 expenditures, the determination of whether the requirements of § 1.263A-1(e)(4)(ii)(C) for mixed service cost classification are satisfied depends upon whether the § 174 expenditures are allocable to non-production or non-resale activities. We conclude under these facts that the engineering department incurs mixed service costs as defined in § 1.263A-1(e)(4)(ii)(C) because the § 174 expenditures are allocable to non-production or non-resale activities.

All of the engineering department's activities, including its research and experimental activities, are related to the electricity generation activity, a production activity. Thus, the Director argues that the § 174 expenditures incurred by the department are allocable to that production activity, even though the § 174 expenditures are exempt from capitalization under § 263A. In essence, the Director argues that the mere fact that a cost is deductible does not mean (1) that it is not allocable to a production activity or (2) that it is allocable to a non-production activity.

The Director points to § 1.263A-1(e)(3)(ii)(P) as support for the conclusion that research and experimental costs, though deductible, are allocable to a production activity. Section 1.263A-1(e)(3)(ii)(P) treats engineering and design expenses properly allocable to property produced or property acquired for resale as capitalizable to a production activity, except to the extent that the expenses qualify under § 174, in which case they are deductible. The Director reasons that the parenthetical exclusion of § 174 expenditures at the end of § 1.263A-1(e)(3)(ii)(P) implies that those § 174 expenditures are allocable to a production activity under the basic definition of a capitalizable indirect cost in § 1.263A-1(e)(3)(ii), but § 174 expenditures are simply excluded from the capitalization requirement by virtue of § 263A(c)(2). In sum, the Director reasons that the statutory exception for § 174 expenditures is necessary because research and experimental costs would otherwise be allocable to production or resale activities and capitalizable under § 263A. The Director maintains that the example in § 1.263A-1(e)(3)(ii)(P) illustrates that fact. In the instant case, the Director concludes that the engineering department cannot be treated as a mixed service department because it only incurs service costs allocable to a production activity.

In addition, the Director points to other costs listed in § 1.263A-1(e)(3)(iii) and posits that if every service department incurring capitalizable and deductible costs were treated as a mixed service department, then even those service departments that provide support solely to production activities would be treated as mixed service departments. For example, each department solely engaging in administration and coordination of

production or resale activities would qualify as a mixed service department if equipment purchased for use by the department were deductible, in whole or in part, under § 179. As another example, the Director states that every materials handling department could qualify as a mixed service department if it were entitled to a § 165 loss because it abandoned outdated equipment or suffered a casualty loss with respect to equipment used by the department.

Admittedly, the inference drawn by the Director from the existence of § 263A(c)(2) and the language of § 1.263A-1(e)(3)(ii)(P) is plausible. However, those provisions are consistent with a conclusion that research and experimental expenditures are attributable to a non-production activity. And we believe the latter is the better conclusion to draw from the existence of § 263A(c)(2) and the language of § 1.263A-1(e)(3)(ii)(P).

On the other hand, we see merit in the Director's argument that the fact that a cost is deductible does not mean that it is allocable to a non-production activity. The definition of a mixed service cost in § 1.263A-1(e)(4)(ii)(C) provides that some of the service costs incurred must be partially allocable to non-production/non-resale activities. The fact that an indirect cost that is listed in § 1.263A-1(e)(3)(iii) is incurred by a service department otherwise incurring production or resale-related costs under the circumstances described above by the Director does not by itself satisfy the definition of a mixed service cost. Rather, the fundamental requirement is that the subject indirect cost must be a service cost that arises from an activity that does not constitute a production or resale activity, that is, from a non-production or non-resale activity.

The Director's examples underscore the distinction regarding the nature of a cost arising from a non-production activity that would satisfy the mixed service cost definition in § 1.263A-1(e)(4)(ii)(C). Engaging in research endeavors that generate § 174 expenditures does constitute an activity that is a non-production activity, whereas the fact that a service department incurring production costs also incurs § 179 costs or sustains § 165 losses does not involve the department engaging in any separate activity with respect to those expenses. Accordingly, those departments would not qualify as mixed service departments solely because they incurred § 179 costs or sustained § 165 losses.

Conversely, if a department otherwise incurring production costs incurs selling and distribution costs, that department would qualify as a service department that incurs mixed service costs under § 1.263A-1(e)(4)(ii)(C) because the selling and distribution costs would arise from an activity that is not allocable to production or resale activities. That scenario is akin to the instant case in that the subject selling and distribution costs would arise from an activity that does not constitute a production or resale activity, that is, such costs arise from a non-production or non-resale activity.

In conclusion, we believe that costs qualifying as research and experimental expenditures under § 174 arise from and are allocable to an activity that is a separate

non-production and non-resale activity within the meaning of § 1.263A-1(e)(4)(ii)(C). Therefore, we conclude that a service department that provides engineering and design services is a mixed service department if some of the costs of the department are allocable to production activities by virtue of § 1.263A-1(e)(3)(ii) and some of the costs of the department are deductible under § 174.

Please call (202) 622-4970 if you have any further questions.