

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

October 28, 2005

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200609018**
Release Date: 3/3/2006
Index (UIL) No.: 263A.03-01, 263A.03-02, 263A.04-04
CASE-MIS No.: TAM-123771-05/CC:ITA:B05

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

<u>Taxpayer</u>	=
<u>systems</u>	=
<u>service</u>	=
<u>X</u>	=
<u>Date 1</u>	=
<u>Federal Agency</u>	=
<u>Y</u>	=
<u>Act</u>	=
<u>Year 1</u>	=
<u>Codes</u>	=

ISSUE(S):

1. Are the labor costs of Taxpayer's engineering department mixed service costs that may be allocated between capitalizable activities and deductible activities?

2. Are the costs of Taxpayer's procurement department mixed service costs that may be allocated between capitalizable activities and deductible activities?

CONCLUSION(S):

1. Taxpayer's engineering department is a service department that to some extent incurs mixed service costs. However, to the extent the costs of the engineering department include costs of labor that can be identified or associated with particular units or groups of units of specific produced property such costs are direct labor costs and not mixed service costs.

2. The costs of Taxpayer's procurement department are mixed service costs.

FACTS:

Taxpayer wholly owns subsidiaries that are regulated public utilities. These subsidiaries operate systems that provide services to customers in X states. Assets used by Taxpayer in providing these services include self-constructed assets as defined by § 1.263A-1(d)(1).

Taxpayer is regulated by both the Federal Agency and state regulatory agencies. Section Y of the Act, as amended, requires that the Federal Agency prescribe a uniform system of accounts for use by companies that provide services. In Year 1, the Federal Agency revised the uniform system of accounts and incorporated the accounting rules into regulations. The Federal Agency's regulations require that Taxpayer assign and allocate costs based on types or pools of cost. The cost pools that are collected by Taxpayer's accounting system and subsequently allocated are described in a cost allocation manual (CAM) that Taxpayer has prepared. The major cost pools listed in the CAM include, among others: (1) engineering labor costs for individuals involved in the planning, design, and implementation engineering of specific projects; (2) engineering supervisions and clerical support; (3) other engineering department costs; and (4) provisioning costs of material and supplies.

The statement of facts included in the request for technical advice submitted by the director and reviewed by Taxpayer provides that these cost pools are allocated to projects, and ultimately to expense or capitalized to assets as follows:

Cost drivers, which determine how costs are "driven" to different projects or to different codes, are collected either in direct reported hours of the project (as is the case for plant and engineering personnel) or in specific dollars of materials used (as is the case for provisions personnel). As previously mentioned certain Plant and Engineering employees are required to report their time to the specific project and/or the specific codes that they are working on. The monetary cost of the materials used in specific projects is also recorded to the specific project and to the specific codes. The direct hours which were time reported to the project

and the monetary dollars for materials used on the project and to each code are multiplied by the applicable standard rate, and these additional calculated costs are then allocated to the project and the code by accounting entities. These standard rates are developed by collecting incurred costs in appropriate cost pools. Each cost pool has certain cost drivers. Then, using rolling twelve month totals, the total cost of a cost pool is divided by the applicable cost driver, equaling the standard rate. The standard rates are developed at certain organization levels called Responsibility Centers (RCs). The RC is the organizational level that has control over the amounts expended.

Taxpayer's engineering department provides project estimates, project planning, and project design to plant department personnel engaged in the construction, maintenance, repair, and removal of Taxpayer's systems. In addition to providing support to personnel engaged in the construction, maintenance, repair, and removal of its systems, Taxpayer's engineering department performs work for other departments. For example, on occasion the engineering department also assists with costs studies being evaluated by the sales and marketing departments. According to Taxpayer's CAM, costs incurred by the engineering department are initially accounted for in one general ledger account and subsequently reassigned to various other general ledger accounts on a monthly basis.

Each activity performed by Taxpayer with regard to the repair, maintenance, removal, and construction activities of its systems is assigned an authorized project number and an alpha code. The alpha codes consist of the following: C for construction activities, R for repairs and maintenance, M for rearrangements, and X for removal activities. For financial reporting purposes, costs classified with a C are capitalized and costs classified with an R, M, or X are expensed. In addition to the alpha code, costs are also tracked using standard number codes. A combination of the alpha code and the standard number code are referred to as codes. Codes are used by the taxpayer to record the specific activity being performed on the type of asset the activity involves. The statement of facts included in the request for technical advice also indicates that an employee reporting his time and who is repairing a pole records his labor and material to with the representing the pole and the representing the activity being performed (repairing the pole). Moreover, an engineer who specifically reports her time and who is working on designing plans for a buried cable would record her hours to the specific authorized project and the specific code. According to the director, in the engineering example, the engineer would record her time to The would represent the asset worked on, the buried cable, and the C would indicate a construction project. Taxpayer's plant accounting handbook provides detailed descriptions of all codes along with guidance for the employees as to the usage of the codes.

According to the CAM, certain "time reporting" employees are required to report the hours they spend working each day. The Federal Agency's regulations identify the labor of a time reporting employee as either "direct plant labor" or "direct engineering

labor.” These engineers perform the design, planning, and implementation engineering functions associated with a specific project that has received authorization and are required to report 100% of their time.

Certain levels of supervisors and support employees in the engineering department do not report their time. Instead, the labor costs of these employees are collected in cost pools and allocated by cost drivers, as provided in the CAM. Federal Agency’s regulations refer to the allocated costs of these non-time reporting employees as “indirect engineering labor.”

As indicated above, Taxpayer initially reviewed and agreed to the above statement of facts. However, at the conference of right on Date 1 and in a subsequent letter, Taxpayer represented that time-reporting engineers do not specifically record their time to codes. Instead, Taxpayer asserted that time-reporting engineers record the hours worked on a specific project, but do not specifically record their time to individual capital or expense activities (codes) within the project. Taxpayer further asserted that the engineers’ reported time is allocated to codes within a specific project based on allocation percentages that are established by a planning engineer who initiated the specific project based on the total projected cost of the project. According to Taxpayer, engineering labor that is reported to a specific project is spread to the codes of projects based on the pre-determined allocation percentages in the following two ways. First, the time reported by the engineer to a specific project could be automatically allocated by the project accounting system based on the estimated code allocations established for the project by the planning engineer. Second, the time reported by the engineer to a specific project may be manually allocated by the engineer using the estimated code allocations established for the project by the planning engineer after the project has been approved. In other words, according to Taxpayer, an engineer that spends all of his or her time working on issues concerning only one code in a project would not specifically report all of his or her time to the code, but would allocate his or her time based on the total cost estimates that were established by the planning engineer.

The director does not agree with Taxpayer’s rendition of the facts. Therefore, since the parties have been unable to reach an agreement on the facts, this technical advice will resolve the issue of whether all of the costs of Taxpayer’s engineering department are mixed service costs in the alternative. See Section 12.12 of Rev. Proc. 2005-2, 2005-1 I.R.B. 86, 109.

Personnel within Taxpayer’s procurement department analyze and evaluate suppliers’ products, select appropriate suppliers, negotiate supply contracts, place purchase orders, develop standards for material purchases and administer vendor or user claims. Certain personnel within the procurement department engage in “provisioning activities.” These provisioning personnel oversee the receiving, stocking and requisitions of materials and supplies that are used in constructing, repairing, and maintaining Taxpayer’s system. Accordingly, Taxpayer’s provisioning costs are the costs associated with the handling of materials and supplies that are used in the

construction and maintenance of Taxpayer's system. Taxpayer's CAM indicates that the acquisition costs of major materials used in an authorized project are recorded directly to the project and the associated code involved (poles, buried cable, etc.). For instance, if a new pole is installed, the pole will be charged to the appropriate code. In contrast, the provisioning costs are collected in a cost pool and allocated based upon the acquisition costs of the materials used.

Taxpayer filed a Form 3115, Application for Change in Accounting Method, for its taxable year ending Date 1 to change its method of allocating mixed service costs. According to the Form 3115, Taxpayer previously used the step-allocation method, taking into account applicable facts and circumstances, to allocate its mixed service costs to self-constructed assets. Under its proposed method, Taxpayer sought approval to use the simplified service cost method to allocate mixed service costs. The Form 3115 also discloses that for this purpose Taxpayer would treat the costs of its engineering department and procurement department as mixed service costs.

LAW

Section 263A generally requires a taxpayer to capitalize the direct costs and an allocable share of the indirect costs of real or tangible personal property that is produced by the taxpayer. The direct costs of produced property include direct materials costs and direct labor costs. See § 1.263A-1(e)(2)(i). Direct labor costs include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced. See § 1.263A-1(e)(2)(B). The indirect costs of produced property are all costs other than direct material costs and direct labor costs. See § 1.263A-1(e)(3). Indirect costs are properly allocable to produced property when the costs directly benefit or are incurred by reason of the performance of production activities. Id. Indirect costs may be allocable to a production activity and other activities that are not subject to § 263A. Accordingly, taxpayers must make a reasonable allocation of indirect costs between production and other such activities. See § 1.263A-1(e)(3)(i).

Indirect costs subject to capitalization under § 263A include indirect labor costs, certain overhead costs, and capitalizable service costs. See § 1.263A-1(e)(3). The regulations define service costs as 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. See § 1.263A-1(e)(4)(i)(A). For this purpose, service departments are defined as administrative, service, or support departments that incur service costs. See § 1.263A-1(e)(4)(i)(B). The mere title of a department or function does not determine whether the department or function constitutes a service department. Instead, the facts and circumstances of the taxpayer's activities and business organization control whether a department is a service department. Id.

The regulations segregate service costs into the following three separate categories: (1) capitalizable service costs, (2) deductible service costs, and (3) mixed service costs. For this purpose, capitalizable service costs are service costs that directly benefit or are incurred by reason of the performance of a production or resale activity of the taxpayer. See § 1.263A-1(e)(4)(ii)(A). Deductible service costs are service costs that do not directly benefit or are not incurred by reason of the performance of a production or resale activity of the taxpayer. See § 1.263A-1(e)(4)(ii)(B). Mixed service costs are service costs that are partially allocable to production or resale activities and partially allocable to non-production or non-resale activities. See § 1.263A-1(e)(4)(ii)(C).

The regulations generally require taxpayers to allocate indirect costs using either a specific identification method, a standard cost method, a burden rate method, or any other reasonable allocation method (as defined under the principles of § 1.263A-1(f)(4)). See § 1.263A-1(g)(3). With regard to mixed service costs, the regulations generally require taxpayers to allocate mixed service costs using reasonable factors or relationships by applying a direct reallocation method, a step-reallocation method, or any other reasonable allocation method (as defined under the principles of § 1.263A-1(f)(4)). See § 1.263A-1(g)(4). The regulations also provide a simplified method (the simplified service cost method) for determining capitalizable mixed service costs. See § 1.263A-1(h).

ANALYSIS

1. Are the labor costs of Taxpayer's engineering department mixed service costs that may be allocated between capitalizable activities and deductible activities?

The director argues that the costs incurred by Taxpayer's engineering department are not mixed service costs. The director argues that the costs incurred by the Taxpayer's engineering department are not mixed service costs because: (1) Taxpayer's engineering department is not a service department, and (2) even if the engineering department is in some part a service department, all the costs of the department are not service costs. The director also contends that the definition of a service department only includes general and administrative departments. The director concludes that since Taxpayer's engineering department does not incur general and administrative expenses, it is not a service department and does not incur mixed service costs that may be allocated using the simplified service cost method. We disagree.

Section 1.263A-1(e)(4) does not limit the definition of service costs to only include the costs of general and administrative departments. Section 1.263A-1(e)(4)(i)(A) provides that "[s]ervice 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." According to the director, the parenthetical after indirect costs

limits service costs to only include general and administrative costs. Contrary to director's argument, the parenthetical does not limit service costs to only include the costs of general and administrative departments. The parenthetical phrase includes the abbreviation e.g., which stands for *exempli gratia*. Translated, *exempli gratia* means for example. Accordingly, the parenthetical only provides an example of indirect costs that may be service costs and does not provide an exhaustive list of indirect costs that may be service costs.

Service costs are a type of indirect 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. See § 1.263A-1(e)(4)(i)(A). Therefore, in order to determine whether the costs of Taxpayer's engineering department are service costs one must first determine whether Taxpayer's engineering department is a service department. Section 1.263A-1(e)(4)(i)(B) defines service departments as administrative, service, or support departments that incur service costs. The regulations do not contain a definitive list of service departments. Instead, the facts and circumstances of a taxpayer's activities and business organization control whether a department is a service department.

The regulations generally permit taxpayers to allocate mixed service costs using reasonable factors or relationships by applying a direct reallocation method, a step-reallocation method, or any other reasonable allocation method (as defined under the principles of § 1.263A-1(f)(4)). See § 1.263A-1(g)(4). In doing so, the regulations also provide illustrations of mixed service cost allocations using reasonable factors or relationships. In particular, section 1.263A-1(g)(4)(iv)(E) provides that the costs of an engineering or design department are generally directly allocable to the departments or activities benefited based on the ratio of the approximate number of hours of work performed with respect to the particular activity to the total number of hours of engineering or design work performed for all activities. Given this example, it is clear that the regulations contemplate that the costs of an engineering department may be viewed as service costs and allocated between capitalizable and deductible activities using various cost allocation methods.

The director also contends that Taxpayer's engineering department is multi-functional and that certain functions of the engineering department may in fact qualify as service functions, but that all functions of the engineering department are not service functions. According to the director, the costs of those functions that are service functions may qualify as mixed service costs, but the costs of those functions that are not service functions are not mixed service costs.

When it enacted § 263A, Congress recognized that existing tax accounting rules provided a large measure of flexibility to taxpayers to allocate costs inasmuch as they permitted any reasonable method of allocation authorized by traditional cost accounting

principles.¹ Accordingly, Congress expected that the Treasury Department would take a similar approach and permit similar allocation methods permitted by cost accounting principles. Congress also recognized that modifications of the rules may be necessary or appropriate in order to adapt such rules to the new capitalization requirements. See S. Rep. No. 99-313, 1986-3 (Vol. 3) C.B. 141-142 (1986).

Accordingly, the Treasury Department promulgated regulations under § 263A that respected the flexibility provided by traditional cost accounting principles by permitting taxpayers to allocate direct costs and indirect costs using a variety of methods. Moreover, the regulations provide that direct labor costs can be allocated as indirect costs provided such costs are capitalized to the extent required by the regulations. See § 1.263A-1(g)(2). The regulations also respected traditional cost accounting principles by permitting taxpayers to allocate mixed service costs using reasonable factors or relationships by applying a direct reallocation method, a step-allocation method, or any other reasonable allocation method (as defined under the principles of § 1.263A-1(f)(4)). See § 1.263A-1(g)(4). Given the flexibility afforded by the regulations to allocate direct and indirect costs using similar allocation methods, the categorization of a cost as either direct or indirect generally is not determinative of the method that may be used to allocate such costs.² However, as explained below, the simplified service cost method provided by the regulations may not be used to allocate direct costs. Therefore, in the context of the simplified service cost method, the determination of whether a cost is a direct or indirect cost is important.

As is indicated above, the simplified service cost method can not be used to allocate direct costs. Section 1.263A-1(h) provides that a taxpayer may use the simplified service cost method to determine capitalizable mixed service costs incurred during the taxable year with respect to eligible property (as defined in § 1.263A-1(h)(2)). For this purpose, 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). Service costs are a type of *indirect costs* that can be identified specifically

¹ Although the legislative history only refers to the flexibility afforded the allocation of indirect costs, the regulations also provided such flexibility to labor costs. See § 1.263A-1(e)(2)(i)(B). Prior to the enactment of § 263A the full absorption regulations provided in § 1.471-11 recognized that many taxpayers may have classified a direct production cost as an item of overhead. Under the full absorption regulations, a taxpayer that classified direct production costs as overhead could continue its method of classifying direct production costs provided the taxpayer treated the costs as overhead allocable to inventory cost. See § 1.471-11(b)(2)(ii). See also Leslie J. Schneider, Federal Income Taxation of Inventories, § 4.03 (1996).

² The regulations generally leave considerable flexibility to taxpayers to categorize labor costs as either direct or indirect because there is not usually a great deal of significance to the distinction because both types of labor costs are subject to capitalization under § 263A. See § 1.263A-1(g). As long as a taxpayer's cost accounting system is designed to assign the labor costs to units of output, there should be no problem with categorizing the cost as either a direct cost or an indirect cost. See Schneider, supra at § 4.03[2].

identified with a service department or function or that directly benefit or are incurred by reason of a service department or function. (Emphasis added.) See § 1.263A-1(e)(4)(A). Accordingly, the simplified service cost method may only be used to allocate a certain type of indirect costs (mixed service costs) and may not be used allocate direct costs. Moreover, although § 1.263A-1(g)(2) provides that a taxpayer is not treated as using an erroneous method of accounting if direct labor costs are treated as indirect costs under the taxpayer's allocation method, the section does not refer to the simplified service cost method. Instead, the section indicates that if direct labor costs are treated as indirect costs they must be capitalized to the extent required by § 1.263A-1(g)(3). Section 1.263A-1(g)(3) provides that indirect costs must be allocated using either a specific identification method, a burden rate method, or any other reasonable allocation method (as defined in § 1.263A-1(f)(4). Section 1.263A-1(g)(3) does not refer to the simplified service cost method.

A close review of the temporary § 263A regulations that preceded the final § 263A regulations also reveals that the drafters of the regulations were aware that a given department could incur a mix of direct costs, indirect costs, and service costs. In particular, § 1.263A-1T(b)(3)(iii)(4)(ii) of the Temporary Regulations, 1987-1 C.B. 98, 111, provided the general rule for allocating administrative, service, or support costs. This rule provided that the total direct and indirect costs (service costs) of administrative, service, or support functions or departments (service departments) that directly benefit a particular production activity must be directly allocated to such activity, but that service costs that benefit production as well as other functions must be allocated to particular activities or functions on the basis of a factor or relationship that reasonably relates the incurring of the service costs to the benefits received by the activity. Like the final regulations, the temporary regulations permitted a taxpayer to allocate service costs by consistently applying any reasonable cost allocation method, including a direct reallocation method, a step-allocation method, or any other reasonable method. However, the temporary regulations also cautioned that none of these methods would be considered a reasonable method if the method effectively allocates service costs to other service departments in such a manner as to avoid the eventual reallocation of such costs to production activities if such reallocation was required under the principles of the regulations. See § 1.263A-1T(b)(3)(iii)(4)(iii). Therefore, under the general rule for allocating service costs provided by the temporary regulations, service costs that directly benefit a particular production activity were required to be allocated to the activity.

Like the final regulations, the temporary regulations also permitted a taxpayer to use the simplified service cost method to allocate its mixed service costs. However, the temporary regulations clarified that for purposes of the simplified service cost method, mixed service costs did not include administrative, support, and service costs that directly benefit or are incurred by reason of the performance of the taxpayer's production activities, if such costs do not benefit other activities of the taxpayer's trade or business, or if such costs were properly allocated to production activities under the taxpayer's method of accounting prior to the effective date of § 263A. See § 1.263A-

1T(b)(6)(i). In other words, under the simplified service cost method as provided in the temporary regulations, mixed service costs did not include the costs of a department that are direct costs of a production activity and costs that were properly allocated to production activities under the taxpayer's method of accounting prior to the effective date of § 263A. Given this regulatory background, it is clear that the final § 263A regulations purposely do not include direct costs within the definition of service costs. In other words, because the final § 263A regulations do not include direct costs within the definition of service costs, like the temporary § 263A regulations, the final § 263A regulations do not permit a taxpayer to use the simplified service cost method to allocate direct labor costs.

At first blush this conclusion may appear to be contrary to § 1.263A-1(h)(6). This section provides that for purposes of the simplified service cost method, total mixed service costs are defined as the total costs incurred during the taxable year in all departments or functions of the taxpayer's trade or business that perform mixed service activities. The section further provides that in determining the total mixed service costs of a trade or business, the taxpayer must include all costs incurred in its mixed service department and cannot exclude any otherwise deductible service costs. However, a close reading of § 1.263A-1(h) reveals that the method allocates only mixed service costs incurred by a mixed service department. First, paragraph (1) of § 1.263A-1(h) states that "this paragraph (h) provides a simplified method for determining *capitalizable mixed service costs* incurred during the taxable year" (Emphasis added.) Second, after stating that total mixed service costs means all costs incurred by departments or functions performing mixed service activities, paragraph (6) of § 1.263A-1(h) refers taxpayers to § 1.263A-1(e)(4)(ii)(C) for a definition of mixed service costs. That definition only includes indirect costs. Thus, it is obvious that the simplified service cost method is a method for allocating indirect costs that qualify as mixed service costs and does not apply to costs that are direct costs.

In the instant case, the director contends that many of the costs incurred by Taxpayer's engineering department are direct labor costs. For example, the director contends that one of the activities performed by Taxpayer's engineering department involves the selection or implementation of designs, materials, and methods for the production of specific plant assets. According to the director, the costs associated with this activity have always been considered by Taxpayer as a direct cost for financial accounting purposes, and, until Taxpayer filed its change in method of accounting, a direct cost for tax purposes. The director further contends that Taxpayer treats the costs of this activity as a direct cost because Taxpayer's books and records for financial accounting purposes directly identifies or associates these costs with particular units or groups of units of specific property produced. The director also contends that certain engineers (time reporting engineers) directly report their time to codes and, therefore, the costs of these time reporting employees should be considered direct labor costs.

Initially, in a brief attached to the director's request for technical advice Taxpayer argued that engineering costs are categorically treated by the regulations as indirect

costs and not direct costs. In support of its argument, Taxpayer cited § 1.263A-1(d)(3)(ii)(P), which provides that engineering and design costs are an example of indirect costs. Taxpayer further argued that direct labor costs only include the costs of production workers that are directly involved in the fabrication of the product. In other words, Taxpayer argued that only the costs of personnel that “touch” the production process are direct labor costs for purposes of § 1.263A-1(e)(2)(B). In support of its argument, Taxpayer cited the “Blue Book to the 1986 Act”, which states that “[d]irect production costs required to be included in an inventory account included the costs of materials forming an integral part of the product or consumed in the manufacturing process, and the costs of labor that were directly involved in fabrication of the product.” See Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 99th Cong., 502 (Comm. Print 1987).

Taxpayer’s argument ignores the definition of direct labor costs contained in § 1.263A-1(e)(2)(i)(B). This section provides that direct labor costs include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced. Using this definition, it is clear that if time reporting engineers directly report their time to codes, the costs of these time reporting employees are being identified or associated with particular units or groups of units of specific property produced, and therefore are considered direct labor costs.

Taxpayer’s arguments also ignore the definition of indirect costs provided in § 1.263A-1(e)(3). This section provides that indirect costs are all costs other than direct material costs and direct labor costs. Section 1.263A-1(e)(3)(ii)(A), which defines indirect labor costs, also clearly provides that indirect labor includes all labor costs that cannot be directly identified or associated with particular units or groups of units of specific property produced (i.e., direct labor costs).

The definition of direct labor costs in § 1.263A-1(e)(2)(i)(B) and our conclusions concerning time reporting engineers that directly report their time to codes are in accord with traditional cost accounting principles. Traditional cost accounting principles recognize that different organizations may attach different meanings to the terms direct labor costs, indirect labor costs, and service costs. See National Association of Accountants, Statement of Management Accounting No. 4C, Definition and Measurement of Direct Labor Cost, Management Accounting, Management Accounting, 67 (October 1985); Charles T. Horngren & George Foster, Cost Accounting, A Managerial Emphasis, 35 (6th ed. 1987). Direct labor has traditionally been defined as labor quantities that can be specifically identified with a cost object in an economically feasible manner. See National Association of Accountants, supra at 67-68; Horngren, supra at 29. For this purpose, a cost objective is generally defined as a product, contract, project, organizational subdivision, or other unit for which costs are measured or estimated. National Association of Accountants, supra at 68. Although this definition has been widely accepted, its application varies because the determination of whether it is economically feasible to directly relate costs must be performed on an entity by entity basis. Accordingly, differences in the way organizations define their costs has in

practice resulted in variations in the amount recorded as direct labor and the amount recorded as overhead. In other words, whether a cost is considered a direct cost must be viewed in the context of the company's cost accounting system, whether the company has determined that it is economically feasible to trace the subject costs directly to a cost objective, and the use for which the term is being employed (e.g., a cost reimbursement contract and income taxes). See Horngren, supra at 35.

The California Franchise Tax Board applied these traditional cost accounting principles to analyze a situation where a taxpayer utilizes the services of its employees for the engineering and design of a new coker. In Legal Ruling 98-1, the California Franchise Tax Board addressed whether certain capitalized costs of labor paid or incurred by a qualified taxpayer for engineering and design services constitute qualified costs for purposes of California's Manufacturers' Investment Credit (MIC). According to the ruling, the MIC is allowable to qualified taxpayers who pay or incur qualified costs on or after January 1, 1994, for qualified property that is placed in service. Qualified costs for this purpose are limited to amounts that are properly chargeable to the capital account of the qualified taxpayer and includes capitalized costs of labor that are directly allocable to the construction or modification of qualified property. See Cal. Rev. & Tax Code §§ 17053.49(d)(3) and 23649(d)(3) (2005). For purposes of the MIC, the term capitalized labor means all direct costs of labor that can be identified or associated with and are properly allocable to the construction, modification, or installation of specific items of qualified property. See Cal.Code.Reg., tit. 18, §§ 17053.49-2(b)(1) and 23649-2(b)(1). To determine whether direct costs of labor are properly allocable to the construction, modification, or installation of a specific item of qualified property, a taxpayer is required to use the same method of allocation that it is required to use under Treas. Reg. § 1.263A-1. See Cal.Code.Reg., tit. 18, §§ 17053.49-2(b)(3) and 2.3649-2(b)(3). Using these criteria, the California Tax Board analyzed a situation where a taxpayer utilizes the services of its employees for the engineering and design of a new coker. See Situations 2 and 3 of Legal Ruling 98-1, supra. In situation 2, the taxpayer does not keep separate records of the time spent by each of the employees performing engineering and design services for the new coker. In this situation, the board held that the wages of the engineers were not qualified costs for purposes of the MIC because the wages are not direct labor costs under § 263A. However, in situation 3, the taxpayer maintained separate records of the number of hours that each engineer spent engineering and designing the new coker. In this situation, the board held that the wages of the engineers are qualified costs for purposes of the MIC because these costs are properly treated as direct labor costs under Treas. Reg. § 1.263A-1.

We also disagree with Taxpayer's interpretation of the cited Blue Book statement. As indicated above, the Blue Book in part states "[d]irect production costs required to be included in an inventory account includes the costs of materials forming an integral part of the product or consumed in the manufacturing process, and the costs of labor that were directly involved in fabrication of the product." See Joint Committee on Taxation, supra. This statement does not support Taxpayer's argument. The statement only indicates that the costs of labor that are directly involved in fabrication of

the product (i.e., labor that touches the product as it is being manufactured) is included in the definition of direct labor and, therefore, must be capitalized. Contrary to Taxpayer's argument, the statement does not limit the definition of direct labor costs to only include the costs of such labor. Moreover, the Blue Book statement does not purport to be a comprehensive definition of direct labor costs.

In this case, the director argues that some of the costs of Taxpayer's engineering department are direct labor costs. In particular, the director contends that the labor costs of time reporting engineers are associated with particular assets because the time reporting engineers specifically assign their costs to a code using either a C, R, M, or X, where a C indicates that the cost is capitalizable. Taxpayer asserts that none of the labor costs incurred by its engineering department can be identified or associated with particular units or groups of units of specific property produced without the use of an allocation method. In other words, Taxpayer asserts that the labor costs incurred by its engineering department are not specifically recorded to capitalizable projects. According to Taxpayer, its time-reporting engineers record the hours worked on specific projects, but do not specifically record the time spent on individual capital or expense activities (codes) within the project. Instead, the engineers reported time is allocated to codes within a specific project based on allocation percentages established by the planning engineer who initiated the specific project, and based on the total projected cost of the project for each code. Likewise, the labor costs associated with supervisors and support employees in the engineering department are not directly associated with a capitalizable project, but instead are collected in cost pools and allocated using cost drivers.

We believe that the two sets of facts provided by the director and Taxpayer result in alternative answers. If the director determines that time reporting engineers specifically track time to codes, such labor constitutes direct labor costs. However, if the director determines that the time reporting engineers do not specifically track time to codes, such labor costs are not direct labor costs. Given this resolution of the issue, the director must process the case consistent with this legal analysis as applied to the facts as they are ultimately determined. See section 12.12 of Rev. Proc. 2005-2, supra.

2. Are the costs of Taxpayer's procurement department mixed service costs that may be allocated between capitalizable activities and deductible activities?

The director contends that the costs incurred by Taxpayer's procurement department are not mixed service costs because its costs do not consist of only general and administrative costs. Alternatively, the director contends that even if the procurement department is considered a service department, the provisioning costs of the department are not mixed service costs because Taxpayer's accounting system already partially identifies these costs with capital projects. The director does not contend, however, that the provisioning costs are direct costs.

As indicated above, we do not accept the director's narrow definition of a service department. Section 1.263A-1(e)(4) does not limit the definition of service costs to only include the costs of general and administrative departments. Contrary to director's argument, service costs are a type of indirect 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. Therefore, in order to determine whether the costs of Taxpayer's procurement department are service costs one must first determine whether Taxpayer's procurement department is a service department. Section 1.263A-1(e)(4)(i)(B) defines service departments as administrative, service, or support departments that incur service costs. The regulations do not contain an exclusive list of service departments. Instead, the facts and circumstances of a taxpayer's activities and business organization control whether a department is a service department. However, the regulations indicate that certain purchasing costs may constitute capitalizable service costs. In particular, § 1.263A-1(e)(4)(iii)(C) provides that the costs of purchasing operations, including materials and equipment, scheduling and coordinating delivery of materials and equipment to and from factories or job sites and expediting and follow-up is an example of capitalizable service costs. This example assumes that because the materials and equipment are delivered to a factory, such materials and equipment will be used for production. However, in some instances purchased materials may not be used in an activity that requires capitalization of the purchasing costs under § 263A. Accordingly, it is clear that the regulations contemplate that the costs of a purchasing department may be viewed as service costs and allocated between capitalizable and deductible activities using various cost allocation methods.

Furthermore, we do not accept the director's argument that the provisioning costs that are incurred in the procurement department are not mixed service costs because such costs are properly allocated to property produced under Taxpayer's existing accounting method. The director's argument is similar to the rules found in the temporary regulations. Under the temporary regulations a taxpayer was not permitted to use the simplified service cost method to allocate administrative, support, and service costs if such costs were properly allocated to production activities under the taxpayer's method of accounting prior to the effective date of § 263A. See § 1.263A-1T(b)(6)(i). The rule provided by the temporary regulations is not contained in the final regulations. See § 1.263A-1(h).³

³ As indicated above, the temporary regulations indicated that for purposes of the simplified service cost method, mixed service costs did not include administrative, support, and service costs that directly benefit or are incurred by reason of the performance of the taxpayer's production activities, if such costs do not benefit other activities of the taxpayer's trade or business, or if such costs were properly allocated to production activities under the taxpayer's method of accounting prior to the effective date of § 263A. See § 1.263A-1T(b)(6)(i). In our analysis of Taxpayer's engineering department we opined that this background made clear that the final § 263A regulations did not include direct costs within the definition of service costs. This opinion was not only supported by the background provided by the temporary regulations, but also the express wording of the definition of service costs provided in § 1.263A-1(e)(4)(A). The director's present argument regarding costs that were properly allocated to production activities under the taxpayer's method of accounting prior to the effective date of § 263A, unlike its

Having concluded that Taxpayer's procurement department is a service department, we believe that all the indirect costs incurred by the department constitute mixed service costs. 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). See § 1.263A-1(e)(4)(ii)(C). In this case, Taxpayer's provisioning costs relate to both production and non-production activities. Accordingly, Taxpayer's provisioning costs must be allocated between capitalizable production activities and deductible activities. Under the final § 263A regulations, all the indirect costs (as opposed to direct costs) incurred in a service department that are partially allocable to production or resale activities or resale activities and partially allocable to non-production or non-resale activities (i.e., mixed service costs) can be allocated between capitalizable and deductible activities using the simplified service cost method.

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.