Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Process Unit

Unit Name	Producer's 263A Computation	
Primary UIL Code	0263A.01-01	Production Activities

Library Level	**Title**
Knowledge Base	Corporate/Business Issues & Credits
Shelf	Inventory and IRC 263A
Book	UNICAP 263A
Chapter	Producers

Document Control Number (DCN)	COR-P-020
Date of Last Update	Revised: 11/07/2024

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Producer's 263A Computation

Note: This Practice Unit supersedes the previously published Practice Unit with the same title published on December 14, 2020. The Practice Unit was updated to delete the law regarding pre-enactment and post-enactment rules for purposes of identifying section 471 costs.

This Practice Unit covers the application of the Uniform Capitalization of Costs under IRC 263A for a taxpayer who is a producer and suggested audit techniques when examining a producer's IRC 263A computation. This Practice Unit will discuss how to:

- determine if the taxpayer produced inventory,
- review the basic law and concepts for IRC 263A and IRC 471,
- identify and determine the amount of additional section 263A costs allocable to production activities,
- determine the amount of section 263A costs capitalized to inventory,
- determine if the taxpayer's allocation method is reasonable,
- apply the change in accounting rules, if necessary.

CAUTION: This Practice Unit focuses on the simplified production method and does not cover the final IRC 263A Treasury Regulations that are effective November 20, 2018. The final treasury regulations still contain the simplified production method. The definitions and methods in the new regulations will be covered in another Practice Unit.

Producer’s 263A Computation

Criteria	Resources
The term "produce" includes constructing, building, installing, manufacturing, developing, improving, creating, raising or growing. See Treas. Reg. 1.263A-2(a)(1)(i). Under IRC 263A, taxpayers must capitalize direct costs and an allocable share of indirect costs to property they produce. To determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production activities. After the taxpayer allocates section 263A costs to the appropriate production activities, the costs are capitalized to the items that remain on hand at the end of the taxable year. See Treas. Reg. 1.263A-1(c)(1). If the taxpayer is using the Simplified Production Method (SPM), review the de minimis rule for producers with total indirect costs of $200,000 or less; if total indirect costs are $200,000 or less, then the taxpayer does not have to capitalize additional section 263A costs to ending inventory. See Treas. Regs. 1.263A-1(b)(12) and 1.263A-2(b)(3)(iv).	▪ IRC 263A ▪ Treas. Reg. 1.263A-1(b)(12) ▪ Treas. Reg. 1.263A-1(c)(1) ▪ Treas. Reg. 1.263A-2(b)(3)(iv)

Process Applicability (cont’d)

Producer’s 263A Computation	
Criteria	**Resources**
Effective for tax years beginning after 12/31/2017, a small business taxpayer is not required to capitalize costs under IRC 263A. See IRC 263A(i). A small business taxpayer is a taxpayer that: ▪ has average annual gross receipts of $25 million or less (indexed for inflation) for the three prior tax years, and ▪ is not a tax shelter as defined in IRC 448(d)(3).	▪ IRC 263A ▪ IRC 448(d)(3)

Summary of Process Steps

Producer's 263A Computation
Process Steps
The process steps below explain how to compute and audit a producer's IRC 263A computation.

Step 1	Determine Whether Producer or Reseller
Step 2	Identify Section 471 Costs
Step 3	Identify Additional Section 263A Costs
Step 4	Allocate MSC to Production Activities

Summary of Process Steps (Cont’d)

Producer’s 263A Computation
Process Steps
The process steps below explain how to compute and audit a producer’s IRC 263A computation.

Step 5	Capitalize 263A Costs to Ending Inventory
Step 6	Evaluate the Taxpayer’s Method
Step 7	Impose a Change in Accounting Method

Step 1: Determine Whether Producer or Reseller

Producer's 263A Computation
Step 1
Determination of Producer or Reseller.

Considerations	Resources
Producers buy goods and transform them into a sellable product, which they sell to their customers for the purpose of making a profit. The Treasury Regulations define the term "produce" as construct, build, install, manufacture, develop, improve, create, raise, or grow. See Treas. Reg. 1.263A-2(a)(1)(i). Therefore, producers include farmers, manufacturers, and construction companies. Examples of producers: ▪ A taxpayer who improves real property it uses in its business. ▪ A taxpayer who creates a drawing for a greeting card that it produces. ▪ A taxpayer who manufactures widgets. ▪ A taxpayer who makes improvements to its property. ▪ A taxpayer who constructs an asset used in its business (for example, a machine or building). ▪ A taxpayer who grows a vegetable crop for sale. A taxpayer may claim to be treated as a service provider or reseller to avoid IRC 263A capitalization rules.	▪ Treas. Reg. 1.263A-2(a)(1)(i)

Producer's 263A Computation
Step 1

Considerations	Resources
The taxpayer may make the following claims to avoid the capitalization of production costs under IRC 263A: ▪ Taxpayer is a service provider. The taxpayer may claim that any property provided to the customer is de minimis and incident to the provision of services. For this claim to be successful: − the taxpayer must meet the definition of a service provider set forth in Treas. Reg. 1.263A-1(b)(11)(ii); − the property must not be inventory in the hands of the taxpayer; and − the property must be de minimis and provided incident to services as set forth in Treas. Reg. 1.263A-1(b)(11)(iii). ▪ Taxpayer is only a reseller. For this claim to be successful, the taxpayer must not produce any property. ▪ Taxpayer is a reseller with only de minimis production activities. For this claim to be successful, the property produced must be de minimis within the meaning of Treas. Reg. 1.263A-3(a)(5). Producers must apply IRC 263A unless an exception applies; for example, the small business taxpayer exception previously described.	▪ Treas. Reg. 1.263A-1(b)(11)(ii) ▪ Treas. Reg. 1.263A-1(b)(11)(iii) ▪ Treas. Reg. 1.263A-3(a)(2)(iii) ▪ Treas. Reg. 1.263A-3(a)(5)

Step 2: Identify Section 471 Costs

Producer’s 263A Computation
Step 2
Identify Section 471 costs.

Considerations	Resources
Under IRC 263A, taxpayers must capitalize their direct costs and an allocable share of their indirect costs to property they produce. To determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production activities. Examiners must properly identify both section 471 costs and additional section 263A costs. The following are section 471 costs: ▪ All direct production costs (Treas. Reg.1.471-11(b)(2)) ▪ Certain indirect production costs (Treas. Reg. 1.471-11(c)(2)) Direct production costs include direct materials and direct labor (Treas. Reg. 1.263A-1(e)(2)). Direct materials costs include the cost of those materials that become an integral part of specific property produced and materials that are consumed in the ordinary course of production and that can be identified or associated with units or groups of units of property produced.	▪ IRC 263A ▪ IRC 471 ▪ Treas. Reg. 1.471-11(b)(2) ▪ Treas. Reg. 1.471-11(c)(2) ▪ Treas. Reg. 1.263A-1(e)(2)

Step 2: Identify Section 471 Costs (cont'd)

Producer's 263A Computation
Step 2

Considerations	Resources
Direct labor costs include the costs of labor that can be identified or associated with units or groups of units of specific property produced. For property produced, indirect costs are all costs other than direct material and direct labor costs. For property acquired for resale, indirect costs are all costs other than acquisition costs. Taxpayers subject to IRC 263A must capitalize all indirect costs properly allocable to property it produces or property it acquires for resale. Indirect costs are properly allocable to property when the costs directly benefit or are incurred because of the performance of production or resale activities. (Treas. Reg. 1.263A-1(e)(3)).	▪ IRC 263A ▪ IRC 471 ▪ Treas. Reg. 1.263A-1(e)(3)

Producer's 263A Computation
Step 2

Considerations	Resources
IRC 471 applies to tangible personal property a taxpayer produces and sells in the ordinary course of its trade or business. Accordingly, IRC 471 does not apply to the costs a taxpayer is required to capitalize to the basis of capital assets. A taxpayer's section 471 costs are the types of costs, other than interest, that a taxpayer capitalizes to property produced or property acquired for resale in its financial statement. Thus, although section 471 applies only to inventories, section 471 costs include any noninventory costs, other than interest, that a taxpayer capitalizes to, or includes in acquisition or production costs of, property produced, or property acquired for resale in its financial statement. A taxpayer determines the amounts of section 471 costs by using the amounts of such costs that are incurred in the taxable year for federal income tax purposes.	▪ IRC 263A ▪ IRC 471 ▪ Treas. Reg. 1.263A-1(d)(2)(i) ▪ Treas. Reg. 1.471-2(f)(7) ▪ Treas. Reg. 1.471-11

Step 3: Identify Additional Section 263A Costs

Producer's 263A Computation
Step 3
Identify Additional Section 263A costs

Considerations	Resources
Section 263A costs are the sum of the taxpayer's section 471 costs, additional section 263A costs, and interest capitalizable under IRC 263A(f). See Treas. Reg. 1.263A-1(d)(4). Additional section 263A costs are the costs, other than interest, that are not included in a taxpayer's section 471 costs but that are required to be capitalized under section 263A. Additional section 263A costs generally do not include the direct costs that are required to be included in a taxpayer's section 471; however, additional section 263A costs must include any direct costs excluded from section 471 costs.	▪ IRC 263A ▪ IRC 263A(f) ▪ IRC 471 ▪ Treas. Reg. 1.263A-1(d)(3)

Step 3: Identify Additional Section 263A Costs (cont'd)

Producer's 263A Computation
Step 3

Considerations	Resources
Taxpayers subject to IRC 263A must capitalize all direct costs and certain indirect costs properly allocable to property it produces (see Treas. Reg. 1.263A-1(e)(1)), without regard to whether the taxpayer incurs the costs before, during, or after the production period. See Treas. Reg. 1.263A-2(a)(3). Note: section 471 costs are inventoriable when incurred during the production process only. Pre-production Costs If a taxpayer holds property for future production, the taxpayer must capitalize direct and indirect costs allocable to such property (e.g., purchasing, storage, handling, and other costs), even though production has not begun. If the taxpayer does not hold property for production, the taxpayer must allocate and capitalize indirect costs incurred prior to the beginning of the production period to the property if, at the time the taxpayer incurs the costs, it is reasonably likely that production will occur at some future date. Thus, for example, a manufacturer must capitalize the costs of storing and handling raw materials before the raw materials are used for production.	▪ IRC 263A ▪ IRC 471 ▪ Treas. Reg. 1.263A-1(e)(1) ▪ Treas. Reg. 1.263A-2(a)(3)

Step 3: Identify Additional Section 263A Costs (cont'd)

Producer's 263A Computation
Step 3

Considerations	Resources
Post-production Costs Generally, producers must capitalize all indirect costs incurred after completion of production that are allocable to the property produced. Thus, for example, storage and handling costs incurred after production while holding the property for sale must be capitalized to the property produced. Service Costs A service cost is an indirect cost (such as general and administrative costs) that a taxpayer incurs within a service department or function. A department that provides direct labor is not a service department because direct labor that can be identified or associated with property produced should be allocated to such property. Examples of service departments include Accounting, Human Resources, Legal and Information Technology. Service costs can be capitalizable, deductible or mixed service costs. Capitalizable service costs are costs that directly benefit or are incurred because of the production or resale activities. For example, the accounting department may employ a plant accountant whose job is specific to the production or resale activity.	

Step 3: Identify Additional Section 263A Costs (cont'd)

Producer's 263A Computation
Step 3

Considerations	Resources
Service Costs (cont'd) Deductible service costs include costs that departments responsible for overall management incur. These costs are generally not allocable to production activities when no substantial cost of such departments benefit a production activity. Overall management and policy departments include those involved in insurance or risk management, internal audit, marketing, selling or advertising. Mixed Service Costs Mixed service costs (MSC) are a subset of additional section 263A costs and are a type of indirect cost requiring capitalization under IRC 263A. See Treas. Reg. 1.263A-1(d)(3). MSC are service costs that are partially allocable to production activities and partially allocable to non-production activities (for example, Accounting, IT, and Security Departments). These departments benefit and support manufacturing operations even though they are not directly involved in the manufacturing process. See the Issue Snapshot, Allocation of Mixed Service Costs when Computing Additional 263A costs for additional information on mixed service cost allocations.	▪ IRC 263A ▪ Treas. Reg. 1.263A-1(d)(3) ▪ Issue Snapshot, Allocation of Mixed Service Costs when Computing Additional 263A costs

Step 4: Allocate MSC to Production Activities

Producer's 263A Computation
Step 4
Allocate MSC to production activities.

Considerations	Resources
Generally, the taxpayer will use the simplified service cost method (SSCM) to allocate MSC between production and non-production activities using the labor-based allocation ratio or the production cost allocation ratio. See Treas. Reg. 1.263A-1(h)(4) and (5). The taxpayer multiplies its total MSC by the allocation ratio to obtain MSC allocable to production activities. The labor-based allocation ratio formula is: $\frac{\text{Section 263A Labor Costs*}}{\text{Total Labor Costs **}}$ *Section 263A labor costs are the total labor costs (excluding labor costs included in mixed service costs) the taxpayer incurs during the tax year that are allocable to property produced and property acquired for resale under IRC 263A. **Total labor costs are the total labor costs (excluding labor costs included in mixed service costs) the taxpayer incurs during the tax year.	▪ IRC 263A ▪ Treas. Reg. 1.263A-1(h)(4) ▪ Treas. Reg. 1.263A-1(h)(5)

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Step 4: Allocate MSC to Production Activities (cont'd)

Producer's 263A Computation
Step 4

Considerations	Resources
The production cost allocation ratio formula is: $$\frac{\text{Section 263A production costs *}}{\text{Total costs **}}$$ *Section 263A production costs are the total costs (excluding mixed service costs and interest) allocable to property produced (and property acquired for resale if the taxpayer is also engaged in resale activities) under IRC 263A that taxpayer incurs during the tax year. **Total costs are all costs (excluding mixed service costs and interest) the taxpayer incurs during the taxable year. Total costs include all direct and indirect costs allocable to property produced (and property acquired for resale if the taxpayer is also engaged in resale activities) and all other costs of the taxpayer's trade or business, including, but not limited to: ▪ salaries and other labor costs of all personnel, ▪ all depreciation taken for federal income tax purposes, ▪ research and experimental expenditures, ▪ selling, marketing, and distribution costs. Such costs do not include taxes described in paragraph Treas. Reg. 1.263A-1(e)(3)(iii)(F).	▪ IRC 263A ▪ Treas. Reg. 1.263A-1(e)(3)(iii)(F)

Step 4: Allocate MSC to Production Activities (cont'd)

Producer's 263A Computation
Step 4

Considerations	Resources
Treas. Reg. 1.263A-1(h)(6) defines total mixed service costs when the taxpayer elects the SSCM to allocate the costs to production as follows: Total MSC are the total costs of all departments or functions of the taxpayer's trade or business that perform mixed service activities. See Treas. Reg. 1.263A-1(e)(4)(ii)(C) which defines mixed service costs. In determining total MSC, the taxpayer must include all costs incurred in its mixed service departments and cannot exclude any otherwise deductible service costs. For example, if the accounting department is a mixed service department, the taxpayer cannot exclude from its total MSC the costs of personnel in the accounting department that perform services relating to non-production activities (e.g., accounts receivable or customer billing activities). Instead, the entire cost of the accounting department must be included in the total MSC. Determine which method the taxpayer used to allocate MSC. Taxpayers may use a variety of methods to allocate MSC among property they produce. For example, two methods are the "facts-and-circumstances" method and the SSCM. See Issue Snapshot, Identifying and Allocating Costs under the Uniform Capitalization Rules of IRC 263A. Also see the following resources: ▪ Job Aid, IRC 263A Mixed Service Cost Allocation Methods ▪ Issue Snapshot, Allocation of Mixed Service Costs when Computing Additional 263A Costs	▪ Treas. Reg. 1.263A-1(h)(6) ▪ Treas. Reg. 1.263A-1(e)(4)(ii)(C) ▪ Issue Snapshot, Identifying and Allocating Costs under the Uniform Capitalization Rules of IRC 263A ▪ Job Aid, IRC 263A Mixed Service Cost Allocation Methods ▪ Issue Snapshot, Allocation of Mixed Service Costs when Computing Additional 263A Costs

Step 4: Allocate MSC to Production Activities (cont’d)

Producer’s 263A Computation
Step 4

Considerations	Resources
Audit Techniques: ▪ Sample and/or secure cost center reports (or similar reports), which should show the activities and interaction of departments, department identification numbers, supervisors, etc. This could lead to identification of potential cost related to production activities included in certain cost centers/departments. ▪ Review the activities of personnel in the taxpayer’s various departments to determine the MSC of the various mixed service departments. ▪ Review the taxpayer’s IRC 263A work papers and supporting documents. Ensure there are allocations from administrative departments, such as accounting, human resources, IT, etc. ▪ Gather information about officers’ activities. Officers involved in production activities should have a portion of their salaries allocated to production. At times, the shareholder/owner/president of a small company is greatly involved in the day-to-day production or operation activities. Therefore, the taxpayer must capitalize the salary and benefits of this officer, including the payroll taxes, because the officer’s activities benefit the production of personal property.	

Step 5: Capitalize 263A Costs to Ending Inventory

Producer's 263A Computation
Step 5
Capitalize Section 263A costs to ending inventory.

Considerations	Resources
The taxpayer may use a specific identification method, burden rate method, standard cost method, the simplified production method, or any other reasonable method to allocate additional section 263A costs to production activities. See Treas. Reg. 1.263A-1(f). Once the taxpayer identifies additional section 263A costs and allocates them to the production activity, the taxpayer must capitalize these costs to the items remaining in ending inventory. Review the method the taxpayer used to make the allocation of costs to ending inventory. The Treasury Regulations set forth various detailed or specific (facts-and-circumstances) cost allocation methods that taxpayers may use to allocate direct and indirect costs to property produced. In addition, in lieu of a facts-and-circumstances allocation method, taxpayers may use the simplified production method. See Treas. Reg. 1.263A-1(f) for allocation methods. The formula for the SPM multiplies the current year section 471 costs remaining on hand at year-end by an absorption ratio.	▪ IRC 263A ▪ IRC 471 ▪ Treas. Reg. 1.263A-1(f)

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Step 5: Capitalize 263A Costs to Ending Inventory (cont'd)

Producer's 263A Computation
Step 5

Considerations	Resources
Treas. Reg. 1.263A-2(b)(3) provides for the Simplified Production Method (SPM). The absorption ratio is calculated as follows: $\dfrac{\text{Additional section 263A costs incurred during the taxable year *}}{\text{Section 471 costs incurred during the taxable year **}}$ *Additional section 263A costs incurred during the taxable year are defined as the additional section 263A costs described in Treas. Reg. 1.263A–1(d)(3) that a taxpayer incurs during its current taxable year. **Section 471 costs incurred during the taxable year are defined as the section 471 costs described in Treas. Reg. 1.263A-1(d)(2)(i) that a taxpayer incurs during its current taxable year. See pre- and post-enactment taxpayer differences in Step 2.	▪ IRC 263A ▪ IRC 471 ▪ Treas. Reg. 1.263A-2(b)(3) ▪ Treas. Reg. 1.263A-1(d)(3) ▪ Treas. Reg. 1.263A-1(d)(2)(i)

Step 5: Capitalize 263A Costs to Ending Inventory (cont'd)

Producer's 263A Computation
Step 5

Considerations	Resources
The taxpayer multiplies its current year section 471 costs remaining in ending inventory or otherwise on hand at the end of each tax year by the absorption ratio. The result is the amount of additional section 263A costs that are added to the taxpayer's ending section 471 costs to determine the section 263A costs that are required to be capitalized.	▪ IRC 263A ▪ Treas. Reg. 1.263A-2(b)(3)(ii)(B)

Step 6: Evaluate the Taxpayer's Method

Producer's 263A Computation
Step 6
Evaluate the taxpayer's method.

Considerations	Resources
Review and evaluate the method the taxpayer used to allocate additional section 263A costs to the items remaining in ending inventory. ▪ Is the IRC 263A amount included on the Form 1125-A, Cost of Goods Sold? − Are additional section 263A costs included in ending and beginning inventory amounts? − Are additional section 263A costs included in line 4? − If the additional section 263A costs are not in either of those places, ask the taxpayer to explain where it recorded the adjustment on the tax return. ▪ Reconcile the IRC 263A and IRC 471 adjustments from the taxpayer's work papers to the Schedule M-3 adjustment. − Inspect the Schedule M-3 and look specifically to the supporting Form 8916-A, Supplemental Attachment to Schedule M-3. − Do you see the IRC 263A adjustment capitalizing the additional costs to ending inventory? Ask the taxpayer where this adjustment is if you do not see it. − Verify that the Cost of Goods Sold as stated on Schedule M-3, Part II and Form 8916-A tie to Form 1125-A. If it there are variances, have the taxpayer reconcile them.	▪ IRC 263A ▪ Form 1125-A, Cost of Goods Sold ▪ Form 8916-A, Supplemental Attachment to Schedule M-3. ▪ Schedule M-3, Net Income Reconciliation

Step 6: Evaluate the Taxpayer's Method (cont'd)

Producer's 263A Computation
Step 6

Considerations	Resources
▪ Taxpayers typically capitalize direct costs and indirect costs under IRC 471. If the taxpayer does not capitalize section 471 costs to inventory (as provided in Treas. Reg.1.471-1 thru 1.471-11 and IRC 263A), then the agent should consider correcting this method. ▪ If the taxpayer is using a simplified method, evaluate to make sure the taxpayer properly applied the method. ▪ If the taxpayer is using a method not discussed in the Treasury Regulations, ask additional questions regarding the method used. For example: – How was the method developed? – How long has the method been used? – Is it a method used by others in the same industry?	▪ IRC 263A ▪ IRC 471 ▪ Treas. Reg. 1.471-1 ▪ Treas. Reg. 1.471-11

Step 6: Evaluate the Taxpayer's Method (cont'd)

Producer's 263A Computation
Step 6

Considerations	Resources
▪ Does the method the taxpayer used capitalize enough costs to provide for a clear reflection of income? − Evaluate how the taxpayer chose the method and if the method is reasonable based on the specific taxpayer production activities. − Treas. Reg. 1.263A-1(f) provides guidance for a reasonable method. − Consider TAM 200437035 where the taxpayer's burden rate did not provide for a clear reflection of income. − An examiner who determines that a taxpayer's method of accounting is impermissible, or that a taxpayer changed its method of accounting without obtaining the consent of the Commissioner, may propose an adjustment for that method only by changing the taxpayer's method of accounting. Contact the Methods of Accounting & Timing Practice Network if you encounter this situation. See Step 7.	▪ Treas. Reg. 1.263A-1(f) ▪ TAM 200437035

Step 7: Impose a Change in Accounting Method

Producer's 263A Computation
Step 7
Impose a Change in Accounting Method.

Considerations	Resources
<u>General Overview</u> In general, an accounting method is a set of rules used to determine when and how a taxpayer takes income and expenses into account for federal income tax purposes. A method of accounting must involve timing. If an accounting practice for an item does not permanently affect the taxpayer's lifetime taxable income but does or could change the year in which taxable income is reported (or in which deductions are claimed), the accounting practice for the item involves timing and is therefore considered a method of accounting. See IRC 446. A Service-imposed change in accounting method (CAM) requires specific written notification to the taxpayer. If the Service does not provide written notice to the taxpayer that it is treating an accounting method issue as a CAM, then the taxpayer's accounting method has not been changed. It is important to properly identify change in accounting method issues and properly compute the IRC 481(a) adjustment. A change to the tax treatment of section 263A costs, methods, allocations, etc. may be a CAM. If multiple change in accounting methods occur in the same year, then method change procedures generally deem the IRC 263A method changes to occur before any other method changes for that tax year. However, there are some changes that do not follow this general rule. See Treas. Reg. 1.263A-7(b).	▪ IRC 263A ▪ IRC 446 ▪ IRC 481(a) ▪ Treas. Reg. 1.263A-7(b)

Step 7: Impose a Change in Accounting Method (cont'd)

Producer's 263A Computation
Step 7

Considerations	Resources
General Overview (cont'd) First, if there is a change to a taxpayer's overall method of accounting, such as from the cash receipts and disbursements method to the accrual method, in the same tax year a change to the method of accounting for section 263A costs, the accrual method change must occur before the IRC 263A change. Second, if there is a change in depreciation method in the same year as a method change of accounting for section 263A costs and any portion of the depreciation is subject to IRC 263A, the change in depreciation method must occur before the IRC 263A change. In addition, there are a few other exceptions to this general rule. Certain LIFO changes made in the same year as changes to a method of accounting for section 263A costs are not required to follow this rule. For example, if there is a change to terminate the use of LIFO method or a change from using the specific goods LIFO method to using the dollar value LIFO inventory method in the same year a change to the method of accounting for section 263A costs, the changes to the LIFO method may occur before the IRC 263A changes.	▪ IRC 263A

Step 7: Impose a Change in Accounting Method (cont'd)

Producer's 263A Computation
Step 7

Considerations	Resources
Changes in Section 263A costs You must determine if a taxpayer has adopted a method of accounting. This is important because once a taxpayer adopts a method of accounting, even an impermissible method, it may not change to a different method of accounting without first obtaining the Commissioner's consent. A taxpayer adopts a method of accounting by using a consistent pattern of treatment. A taxpayer adopts a permissible method of accounting by using the method to compute taxable income on its first tax return or the first tax return that reflects the material item. A taxpayer adopts an impermissible method of accounting for a material item by treating the item in the same way on two or more consecutively filed tax returns (see Rev. Rul. 90-38 and Rev. Rul. 72-491). A material item is any item of income, deduction, gain or loss that involves timing (section 263A costs). An impermissible method is one that does not clearly reflect taxable income. If you determine a taxpayer adopted an impermissible accounting method for its section 263A costs or did not properly obtain the Commissioner's consent before changing its accounting method for section 263A costs, you should propose a Service-imposed change in accounting method. Rev. Proc. 2002-18 provides the procedures for a Service-imposed change in accounting method.	▪ IRC 263A ▪ Rev. Proc. 2002-18 ▪ Rev. Rul. 72-491 ▪ Rev. Rul. 90-38

Producer's 263A Computation
Step 7

Considerations	Resources
Changes in Section 263A costs (cont'd) You can find additional information on Service-imposed method change issues in the Knowledge Management Servicewide Virtual Library (VL) by going to the Examination floor, then the Corporate/Business Issues & Credits Knowledge Base (KB) and selecting the Change in Methods book on the Methods of Accounting and Timing shelf. In general, a taxpayer requesting a change in accounting method must file an application for change in accounting method (Form 3115) prospectively, using either the automatic or the non-automatic (advance) method change consent procedures in Rev. Proc. 2015-13. You can find additional information on voluntary method change procedures in the Change in Methods book. If you determine a taxpayer adopted an IRC 263A method of accounting that does not clearly reflect income (i.e., impermissible method), you should initiate an involuntary change in accounting method by calculating an IRC 481(a) adjustment and a current year adjustment. Do this by recalculating the taxpayer's beginning and ending capitalized section 263A costs under the new method of accounting. Generally, propose the CAM adjustment in the first year under examination. There is no spread of the IRC 481(a) adjustment for a Service – imposed method change, you must include the entire amount of the IRC 481(a) adjustment in the year of change.	▪ IRC 263A ▪ IRC 481(a) ▪ Rev Proc. 2015-13 ▪ Form 3115, Application for Change in Accounting Method ▪ Corporate/Business Issues & Credits KB, Change in Methods Book, Voluntary Change in Method ▪ Corporate/Business Issues & Credits KB, Change in Methods Book, IRC 446(b): Service-Imposed Method Change Issues ▪ Corporate/Business Issues & Credits KB, Change in Methods Book, IRC 481(a) Adjustments

Definitions

Producer's 263A Computation
Description
▪ Treas. Reg. 263A Labor Costs – are defined as the labor costs allocable to property produced less mixed service labor cost. See Step 4 for further guidance. ▪ Treas. Reg. 263A Production Costs – are defined as the total costs (excluding mixed service costs and interest) allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities). See Steps 3 and 4 for further guidance. ▪ Mixed Service Costs – service costs that are partially allocable to production activities and partially allocable to non-production activities. See Step 4 for further guidance. ▪ Producer – the Treasury Regulations define produce as construct, build, install, manufacture, develop, improve, create, raise, or grow, see the Process Applicability section for further explanation. ▪ Simplified Production Absorption Ratio – the simplified production absorption ratio is calculated as the additional Treas. Reg. 263A costs incurred during the taxable year divided by the Treas. Reg. 471 costs incurred during the taxable year. See Step 5 for further guidance. ▪ Total Costs – are all costs (excluding mixed service costs and interest) incurred in the taxpayer's trade or business during the taxable year. Total costs include all direct and indirect costs allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities). See Step 4 for further guidance. ▪ Total Labor Costs – are defined as total labor costs in all departments of the taxpayer's trade or business less mixed service labor costs. See Step 4 for further guidance.

Other Considerations / Impact to Audit

Producer's 263A Computation	
Considerations	**Resources**
▪ Consider interest capitalization rules under IRC 263A(f) for any self-constructed assets.	▪ IRC 263A(f) ▪ Practice Unit, Interest capitalization for Self-Constructed Assets
▪ Once IRC 263A(f) costs are capitalized to self-constructed assets, depreciation should be updated due to the change in the basis of the asset.	
▪ Taxpayer's gross receipts may vary from year to year causing the taxpayer to meet the small taxpayer exception one year and not the next. Review the CAM procedures for this occurrence.	▪ TCJA Inventory and Accounting Method Changes, 2019 CPE ▪ Rev. Proc. 2018-40
▪ Be aware of the new regulations for negative section 263A costs and new modified simplified production method.	▪ TD 9843 ▪ Rev. Proc. 2018-56

Index of Referenced Resources

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Rev. Rul. 90-38
Rev. Proc. 2002-18
Rev. Proc. 2015-13

Index of Referenced Resources (cont'd)

Producer's 263A Computation
Rev. Proc. 2018-40
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TAM 200437035
TD 9843
Corporate/Business Issues & Credits KB, Change in Methods Book, Voluntary Change in Method
Corporate/Business Issues & Credits KB, Change in Methods Book, IRC 446(b): Service-Imposed Method Change Issues
Corporate/Business Issues & Credits KB, Change in Methods Book, IRC 481(a) Adjustments
Form 1125-A, Cost of Goods Sold
Form 3115, Application for Change in Accounting Method
Form 8916-A, Supplemental Attachment to Schedule M-3
Schedule M, Net Income Reconciliation
Issue Snapshot, Allocation of Mixed Service Costs when Computing Additional 263A costs
Issue Snapshot, Identifying and Allocating Costs under the Uniform Capitalization rules of IRC 263A
Job Aid, Section 471 and Additional 263A Costs for 263A Purposes
Job Aid, IRC 263A Mixed Service Cost Allocation Methods
TCJA Inventory and Accounting Method Changes, 2019 CPE

Training and Additional Resources

Producer's 263A Computation	
Type of Resource	**Description(s)**
Issue Toolkits	▪ Issue Snapshot - Identifying and Allocating the Costs of Self-constructed Assets under IRC 263A ▪ Issue Snapshot - Capitalizing the Acquisition Costs of Renewable Identification Numbers (RINs) ▪ Issue Snapshot - IRC 263A Calculation for LIFO Taxpayers Electing the Simplified Production Method or the Simplified Resale Method ▪ Issue Snapshot - Capitalization of Costs for the Restaurant Industry under IRC 263A
Reference Materials	▪ Job Aid, Audit Steps for an IRC 263A Computation for a Non-LIFO Producer ▪ Job Aid, IRC 263A Producers ▪ Job Aid, IRC 263A Service Costs ▪ Job Aid, IRC 263A FIFO Spreadsheet – Labor based ▪ Job Aid, IRC 263A FIFO Spreadsheet – Production ▪ Job Aid, Mixed Service Cost Allocations ▪ Job Aid, Pre-Audit Steps When Reviewing Inventory & IRC 263A ▪ Comprehensive IRC 263A CPE Part I, 022416 ▪ Comprehensive IRC 263A CPE Part II, 030416

Glossary of Terms and Acronyms

Term/Acronym	Definition
CAM	Change in Accounting Method
FIFO	First in First Out (method for accounting for inventory)
IRC	Internal Revenue Code
KB	Knowledge Base
LIFO	Last in First Out (method for accounting for inventory)
MSC	Mixed Service Costs
Rev. Proc.	Revenue Procedure
SPM	Simplified Production Method
SSCM	Simplified Service Cost Method
TAM	Technical Advice Memorandum
TD	Treasury Decision
Treas. Reg.	Treasury Regulation
UNICAP	Uniform Capitalization
VL	Virtual Library

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
263A.08-00	Interest Capitalization
263A.03-00	Capitalization Costs
263A.04-05	Modified Simplified Production Method
263A.07-00	IRC 481(a) Adjustment for IRC 263A Adjustments