

IRS business plan includes important guidance on tax accounting issues

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In brief

With the recent release of the final tangible property 'repairs' regulations, taxpayers may be interested in some of the 21 other tax accounting guidance projects on the 2013-2014 IRS-Treasury Priority Guidance Plan, commonly referred to as the 'business plan.' While most of these items have been carried over from previous business plans, there are several important new items.

The tax accounting items on the new business plan cover a wide range of transactions and therefore should be of interest to many taxpayers. The business plan also includes some related items in other sections. This WNTS Insight addresses several of the tax accounting projects in the new business plan.

For discussion of the repairs regulations, see WNTS Insight, "[IRS releases long-awaited final tangible property 'repairs' regulations](#)," September 13, 2013; WNTS Insight, "[Final tangible property repair regulations: Effective dates, materials and supplies, de minimis rule, and rotatable spare parts](#)," September 18, 2013; WNTS Insight, "[Final tangible property repair regulations: Unit of property and acquisition or improvement of property](#)," September 26, 2013; and WNTS Insight, "[Final tangible property repair regulations and proposed regulations: Dispositions, general asset accounts, recovery of certain capital improvements, and removal costs](#)," October 7, 2013.

In detail

Negative Section 263A amounts

Item 4 under Tax Accounting is "Final regulations under §263A regarding the inclusion of negative amounts in additional §263A costs."

Under Section 263A, taxpayers must capitalize all direct costs and indirect costs that directly benefit or are incurred by reason of the performance of production or resale activities. For financial accounting (book) purposes, certain costs of producing property or acquiring

inventory for resale are treated as capitalizable costs -- e.g., as fixed assets or inventory (generally considered Section 471 costs). For tax purposes, the costs required to be capitalized under Section 263A typically differ both in type -- due to different capitalization requirements -- and in amount -- due to book-tax differences -- from the costs capitalized for book purposes.

Observation: Under Section 263A, a taxpayer therefore must analyze the costs capitalized under its financial accounting system to identify all the

'additional costs' that Section 263A requires to be taken into account that were not previously included -- e.g., offsite storage, excess tax depreciation, and unfavorable variances -- or that Section 263A does not require to be taken into account that were previously included -- e.g., 'pick and pack' costs, excess book depreciation, and favorable variances.

If a taxpayer's Section 263A activity involves inventory, once the taxpayer has identified the additional costs that must be taken into account under Section 263A (known as

‘additional Section 263A costs’), those costs must be allocated between ending inventory and cost of goods sold. In general, Section 263A provides that additional Section 263A costs may be allocated between ending inventory and cost of goods using ‘facts and circumstances’ allocation methods, such as a burden rate method and a standard cost method, or using simplified methods, specifically the simplified production method (SPM) or the simplified resale method (SRM). Each of these simplified methods utilizes inventory turnover type ratios to allocate additional Section 263A costs between ending inventory and cost of goods sold.

In Notice 2007-29, the IRS requested comments on the treatment of negative additional Section 263A costs (negative amounts) under the simplified methods. Negative amounts generally occur when a taxpayer capitalizes a cost for book purposes that is not required to be capitalized for tax purposes or has a favorable book-tax difference for a cost that is capitalized for both book and tax purposes.

Proposed regulations issued in September 2012 under Section 263A address whether negative amounts are allowable in applying the simplified methods provided by the existing Section 263A regulations. In particular, the proposed regulations bar the use of negative amounts for large taxpayers unless the taxpayer uses the SRM or the proposed modified simplified production method (MSPM). As a result, if the regulations are finalized as proposed, virtually all large producers would be required to change their Section 263A method either to use the MSPM or to remove negative amounts from their Section 263A calculations. Both options could increase significantly the complexity of complying with

Section 263A. The proposed regulations, if finalized, would apply to tax years ending on or after the date they are published as final regulations in the Federal Register.

The IRS requested comments on all aspects of the proposed regulations. In particular, the IRS asked for comments on the MSPM, including: (1) whether distortions will occur if preproduction related additional Section 263A costs are not directly traced from raw materials through WIP and finished goods inventories from year to year; (2) how mixed service costs should be allocated between raw materials, work-in-process, and finished goods inventories under the new formula; and (3) how the new formula should apply to a taxpayer using the LIFO method of accounting.

For additional discussion of the proposed Section 263A regulations, see WNTS Insight, [“Proposed rules on negative additional section 263A costs”](#) would require many producers to change their UNICAP method,” September 7, 2012.

Deferred revenue in certain corporate transactions

Item 22 under Tax Accounting is “Guidance regarding the treatment of deferred revenue in taxable asset sales and acquisitions.”

This is a new item on the business plan, but, as the New York State Bar Association explained in a report issued earlier this year, “the proper tax treatment by the buyer of the assumption of a deferred revenue liability of the seller in a taxable asset acquisition of a business” is an issue of longstanding uncertainty. Deferred revenue liabilities are created when a customer makes a prepayment for goods or services, such as a prepaid magazine subscription. The wording of the guidance plan item seems to

indicate that the IRS also plans to address the proper tax treatment of the seller in such transactions.

Section 199 and computer software

Item 32 under General Tax Issues is “Regulations under §199 relating to computer software.” Government officials have indicated that this guidance project, which likely will be proposed regulations, is intended to address issues relating to traditional downloaded computer software as well as online computer software. Specifically, modifications to the existing Section 199 regulations may relate to the definition of computer software as well as qualification issues related to both the “self-comparable” and “third-party” comparable exceptions for online software.

Advance payments

Item 12 under Tax Accounting is “Regulations under Section 451 regarding advance payments received for goods and services, including amounts received in exchange for the sale or issuance of gift cards, trading stamps, and loyalty points that can be redeemed for goods or services.”

This is a new item on the business plan. Based on public comments by government officials, this project, which likely will be proposed regulations, is intended to provide a single set of rules for all types of advance payments. Guidance issued by the IRS in recent years suggests that the IRS views the existing rules under Reg. sec. 1.451-4, which address the treatment of trading stamps and premium coupons, as made obsolete by the economic performance rules under section 461(h). In order to address this issue, along with the differences in the existing rules under Reg. sec. 1.451-5 and Rev. Proc. 2004-34 for advance payments, the IRS appears to be contemplating one set of rules that would govern the timing of

revenue recognition for advance payments and loyalty programs.

Retailers

Four items in the Tax Accounting section of the new business plan address issues for taxpayers in the retail industry:

- Final regulations under Sections 263A and 471 regarding sales-based royalties and sales-based vendor allowances. Proposed regulations were published on December 17, 2010.”
- “Final regulations amending Section 1.471-8 regarding the

treatment of vendor allowances under the retail inventory method. Proposed regulations were published on October 7, 2011.”

- Revenue Procedure under Section 263(a) regarding capitalization versus repair issues associated with certain retail store expenditures (e.g., store refreshes).

The IRS has completed the fourth business plan item relating to retailers by publishing Rev. Proc. 2013-29, which clarifies that advance payments received from the sale of gift cards redeemable by unrelated entities generally qualify for deferral from

gross income under the provisions of Rev. Proc. 2004-34. For discussion of Rev. Proc. 2013-29, see WNTS Insight, “[IRS clarifies income deferral rules for gift cards](#),” July 31, 2013.

The takeaway

The tax accounting guidance projects on the new business plan address issues related to many common types of transactions and activities and therefore could affect many business taxpayers. Taxpayers should gain an understanding of how these projects could affect them.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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