
WNTS Insight

A Washington National Tax Services (WNTS)
Publication

September 7, 2012

Proposed rules on "negative additional section 263A costs" would require many producers to change their UNICAP method

The IRS on September 4 issued proposed regulations under section 263A addressing whether "negative additional section 263A costs" (negative amounts) are allowable in applying the simplified methods provided by the existing section 263A regulations. Section 263A requires taxpayers to capitalize all direct costs and indirect costs that directly benefit, or are incurred by reason of, the performance of production or resale activities.

In particular, the proposed regulations bar the use of negative amounts for large taxpayers unless the taxpayer uses the simplified resale method (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 section 263A.

The new regulations are proposed to apply to tax years ending on or after the date they are published as final regulations in the Federal Register. Notice 2007-29 (discussed below) would be superseded as of that date.

Background

As noted above, 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.

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 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.

Negative amounts under Notice 2007-29

In Notice 2007-29, the IRS requested comments on the treatment of 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.

For example, the Notice indicates that if a taxpayer includes book depreciation in its capitalizable costs for book purposes, and the book depreciation is greater than tax depreciation for the year, the taxpayer may have capitalized more depreciation than must be capitalized under section 263A. A negative amount results if the taxpayer removes the excess depreciation by making a negative adjustment to its additional section 263A costs, and uses its section 263A allocation method to remove the cost from ending inventory (as opposed to removing the cost using its financial accounting allocation methods).

Notice 2007-29 states that, pending issuance of additional published guidance, the IRS would not challenge the inclusion of negative amounts in computing additional costs under section 263A or the permissibility of aggregate negative additional section 263A costs.

Proposed regulations generally prohibit negative amounts

The proposed regulations generally would prohibit inclusion of negative amounts as additional section 263A costs, subject to three exceptions. The IRS rationale for this proposed prohibition is that including negative amounts under the simplified methods could result in distortions because the amount removed from ending inventory for tax purposes under section 263A could exceed the amount capitalized to ending inventory for book purposes under section 471.

Under the first exception, a taxpayer using the SRM may include negative amounts (other than cash or trade discounts) in its additional section 263A costs. The IRS indicated it allows this exception because it believes negative amounts cause less distortion under the SRM than under the SPM.

Under the second exception, producers with average annual gross receipts for the three previous tax years of \$10 million or less may include negative amounts (other than cash or trade discounts) in additional section 263A costs in applying the SPM.

Under the third exception, a taxpayer may take negative amounts (other than cash or trade discounts) into account under the new MSPM because this new method is believed to reduce the distortions that exist under the traditional SPM by more precisely allocating additional section 263A costs to ending inventory.

Observations: The proposed regulations provide that if a taxpayer is not able to reduce its additional section 263A costs for negative amounts, the taxpayer must reduce its section 471 costs using a "reasonable method that approximates the manner in which the taxpayer originally capitalized the costs to its inventory (or other eligible property) in its financial statements." This requirement likely would add significant complexity to affected taxpayers because taxpayers typically do not have separate section 471 cost allocation systems for tax purposes, and their book cost accounting systems typically cannot be adjusted for tax costs.

New modified simplified production method

As indicated above, the proposed regulations would offer an alternative simplified method, the MSPM, under which a producer would be able to take negative amounts (other than cash or trade discounts) into account in determining additional section 263A costs. The MSPM would allow the use of two separate absorption ratios -- a preproduction absorption ratio and a production absorption ratio -- to determine the additional section 263A costs capitalized to ending inventory.

Preproduction cost absorption ratio:

Preproduction additional section 263A costs incurred during the year X Raw material costs in ending inventory*

Raw material costs incurred during the year*

*For this purpose, raw materials costs incurred during the year and in ending inventory would include the cost of unprocessed raw materials, as well as raw material costs that are integrated into work-in-process (WIP) and finished goods.

Production cost absorption ratio:

Additional section 263A costs incurred during the year related to production and post-production X Production section 471 costs in ending inventory**

Production section 471 costs incurred during the year**

**For this purpose, production section 471 costs incurred during the year and in ending inventory do not include raw material costs.

The sum of the allocable preproduction additional section 263A costs and the allocable production additional section 263A costs would be the taxpayer's total additional section 263A costs allocable to ending inventory.

Observations: The MSPM arguably would be less distortive than the SPM because it more accurately allocates additional costs to the inventory to which they relate by allocating preproduction costs only to raw materials and production costs only to WIP and finished goods. In fact, the MSPM could be more favorable than the SPM for taxpayers with significant raw material or in-transit inventory. However, a taxpayer may find it difficult to identify raw material costs in WIP and finished goods because such amounts typically are not readily identifiable in its books and records. In addition, producers currently ineligible to use the SPM also would be ineligible to use the MSPM, and thus would appear to be ineligible to reduce section 263A costs by negative amounts.

Comments requested

The IRS has requested comments on all aspects of the proposed regulations. In particular, the IRS asks 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, WIP, 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.

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