

IRS takes aim at UNICAP accounting methods used by retail and consumer companies

Recent guidance issued by the IRS over the past year coupled with increased IRS exam activity may have far-reaching implications for how retailers and consumer products manufacturers (Retail & Consumer companies) account for their inventories in the months and years ahead.

For most of the past 20 years, following passage of the 1986 tax reform legislation, the IRS has occasionally published unfavorable guidance dealing with inventory accounting methods. However, in the past year, such rulings, specifically those related to the uniform capitalization (UNICAP) rules under §263A, have appeared with increasing frequency.

While it is not clear whether an ideological shift has prompted stepped-up IRS exam activity regarding the UNICAP rules, what is clear is the agency's intention to thoroughly review Retail & Consumer companies' UNICAP calculations and methodologies during the course of an IRS audit.

Briefly stated, the UNICAP rules were designed to eliminate much of the flexibility companies had to determine which costs were

included in inventory for tax purposes. Prior to 1987, most companies simply used the same inventory methods for both financial statement and tax purposes.

By contrast, the UNICAP rules require manufacturers and most retailers to include indirect expenditures in their inventory costs for tax purposes, regardless of the financial statement treatment for those expenditures. More specifically, taxpayers subject to §263A must capitalize all direct and certain indirect costs allocable to:

- Real and tangible personal property produced by the taxpayer (regardless of whether the property is sold or used in a trade or business.)
- Real and personal property acquired by the taxpayer for resale.

Thus far, Retail & Consumer companies have done little to anticipate the IRS' scrutiny of their UNICAP calculations. Few have taken steps to review their UNICAP calculations to identify potential issues. Fewer still have developed strategies to deal with a possible IRS challenge to their UNICAP methods.

However, now may be the time for Retail & Consumer companies to conduct a thorough review of their UNICAP calculations and develop a plan of action.

Changing environment

While some of the recently issued UNICAP rulings will have little or no impact on any company beyond the one being audited, other guidance is likely to affect how all Retail & Consumer companies account for inventory in the future. These include:

TAM 200446024 – A retailer had received permission from the IRS to change its method of allocating mixed service costs under §263A. Based on that IRS ruling letter, the retailer treated its merchandising (purchasing) department as a mixed service department. The examining agent challenged this treatment, and the IRS National Office concluded that a retailer's purchasing department is not a mixed service department.

This Technical Advice Memorandum (TAM) could have a significant impact on retailers who are currently treating purchasing departments as mixed service departments. Under §263A, companies may elect to use the simplified service cost method

(SSCM) to allocate mixed service costs between capitalizable and non-capitalizable activities. The SSCM allocates mixed service costs to purchasing activities by applying a ratio of §263A purchasing labor costs to total labor costs. Where there are no purchasing costs outside of those in the purchasing departments, and the purchasing departments are treated as mixed service departments, the numerator of the SSCM allocation ratio would be zero. In this situation, no purchasing costs would be capitalized, resulting in significantly understated UNICAP costs. Retailers who have treated purchasing departments as mixed service departments should consider changing to a method that treats purchasing department costs as indirect costs under §263A. A retailer that properly and timely files such a voluntary accounting method change request could take the increase in UNICAP costs into income over four tax years.

TAM 200437035 – A manufacturer treated raw material storage and handling costs as indirect production costs and allocated these costs to inventory using a standard cost method for financial reporting and tax purposes. The manufacturer's standard cost method used direct labor as the basis for allocating indirect production costs, including raw material storage and handling costs, to inventory. The examining agent challenged this method for allocating raw material storage and handling costs, and the IRS National Office concluded that direct labor could not be used as the basis for allocating raw material storage and handling costs.

This Technical Advice Memorandum has far-reaching implications for consumer products manufacturers and retailers alike because it concludes that, when a taxpayer capitalizes costs subject to §263A for financial reporting purposes, the IRS

can challenge the financial reporting methods used to allocate those costs to inventory. Most taxpayers and tax practitioners believe that the enactment of the UNICAP rules did not require taxpayers to change financial reporting methods used to allocate costs to inventory. If taxpayers are forced to change these methods to comply with the UNICAP rules, the compliance costs would be substantial because taxpayers would have to develop new inventory costing systems. Clearly, this could not be an intended consequence of the UNICAP rules, yet the IRS has reached this conclusion in TAM 200437035.

Many other issues are currently being raised in IRS exams. For instance, the capitalization of royalty expenses under UNICAP continues to be a hot topic. It appears that *Plastic Engineering & Technical Services, Inc. v. Commissioner of Internal Revenue*, TCM 2001-324, has opened the door for increased scrutiny of royalty expenses, even in situations with fact patterns far different from those in *Plastic Engineering*.

The practice of using “negative §263A costs” also is coming under increased scrutiny in IRS exams. Companies have routinely used negative §263A costs (e.g., credits in the numerator of the simplified method ratios) to account for costs that were included in §471 costs, but are not capitalizable under the UNICAP rules. While typically this practice simply reduces additional §263A costs, it sometimes results in net negative §263A costs. The IRS has expressed concerns with this practice in both circumstances.

IRS agents also have been aggressively attacking the use of the simplified resale method by retailers of private label goods. The IRS is asserting that, although the companies are retailers, they are not “resellers” under the UNICAP rules but, rather, producers of the private label goods. As such, the IRS is

arguing that retailers of private label goods are not eligible to use the simplified resale method and should use the simplified production method instead.

This heightened IRS attention to UNICAP is not limited to controversial or complex issues. Exam activity continues to uncover improper UNICAP methods. Companies who have not paid close attention to UNICAP methodologies may find that their methods have not kept up with business or accounting system changes. UNICAP methods may have improperly evolved over time. Companies may be using over-simplified UNICAP methods or none at all. Even if the IRS has not uncovered these exposures in the past, it seems likely that the IRS would identify them now due to the increased focus on UNICAP methods.

Planning opportunities emerge

Based on these developments, Retail & Consumer companies could benefit by conducting a UNICAP review. Companies that take control of their UNICAP computations now could limit the ability of the IRS to dictate which UNICAP methods they must use in the future.

Where exposures exist, it may be better for companies to correct these exposures rather than having to use the UNICAP methods determined by the IRS on examination. Proactive companies who undertake a UNICAP review now can identify and mitigate exposures and IRS audit adjustments. Companies that act to correct exposures by filing a Form 3115 to change their UNICAP methods are granted audit protection. In addition, they are allowed to take the income adjustment over four years, while those who wait for UNICAP issues to be discovered in an IRS exam must take the income into account in one year, usually the earliest year under exam.

Along with any exposures that may exist, opportunities may be found as well. There are many circumstances in which companies may be overcapitalizing UNICAP costs. Filing a Form 3115 to change the treatment of these costs could result in a significant decrease in capitalized costs. Companies that act to seize such opportunities by filing a Form 3115 are allowed to take the entire deduction in the year of change.

Finally, opportunities may exist to relieve the administrative burden associated with UNICAP through simplifications in the UNICAP methodology.

Conclusion

While the application of the UNICAP rules may once have garnered little attention from the IRS, increased IRS attention shown in the issuance new guidance, as well as in increased exam activity in recent days, should serve as a wake up call for Retail & Consumer companies that have grown content with outdated, risky UNICAP methods.

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