Tax Insights
from Accounting Method Services

Section 263A final regulations provide new modified simplified production method

December 20, 2018

In brief

The IRS and Treasury recently published final regulations on the treatment of 'negative additional Section 263A' costs that arise when a taxpayer uses a simplified method to allocate costs to ending inventory (EI). Under Section 263A, also known as uniform capitalization (UNICAP), taxpayers required to maintain inventories must capitalize (i.e., treat as inventory costs) all direct costs and certain indirect costs allocable to production or resale activities.

The final regulations generally apply for tax years beginning on or after November 20, 2018. Thus, calendar-year taxpayers must comply with the regulations beginning in 2019. For tax years that both begin before and end after November 20, 2018 (for example, calendar year 2018), the preamble states that the IRS will not challenge tax positions consistent with the final regulations. The final regulations can be accessed here.

The IRS also released Rev. Proc. 2018-56, which provides automatic consent and procedures for taxpayers to change their methods of accounting consistent with the final regulations. The revenue procedure can be accessed here.

This Insight discusses in detail the rules in the final regulations relating to the new modified simplified production method (MSPM), and the rules in the final regulations and Rev. Proc. 2018-56 relating to methods of accounting and method changes. For a discussion of rules in the final regulations on the definition of Section 471 costs for purposes of Section 263A and the use of negative adjustments to additional Section 263A costs, see Final regulations provide complex rules on negative additional Section 263A costs. PwC professionals discussed the regulations in a webcast on December 18, 2018, which can be viewed here.

In detail

Background

Additional Section 263A costs

Before UNICAP was enacted in 1986, taxpayers with inventories identified capitalizable costs and allocated those costs to EI and cost of goods sold (COGS) under Section 471. Section 471 costs and methods generally were synonymous with costs and methods used for financial accounting (book) purposes. Section 471 costs for manufacturers typically included direct costs (i.e., direct materials and direct labor) and certain indirect costs (e.g., overhead such as depreciation).

Section 263A generally requires taxpayers subject to UNICAP (generally producers and resellers) to capitalize other indirect costs to inventory in addition to costs capitalizable under Section 471. Taxpayers must capitalize all indirect costs that directly benefit or are incurred by reason of the performance of production or resale activities.

Additional Section 263A costs are the costs, other than interest, not included in a taxpayer's Section 471 costs that must be capitalized under Section 263A. Additional Section 263A costs generally increase the amount of costs capitalized to EI. However, in some cases, taxpayers may include costs in their book inventory costs (i.e., as Section 471 costs) that they are not required or permitted to capitalize under Section 263A, or the tax amount of the costs may be less than the book amount of the costs (due to book-tax differences). Taxpayers often removed these costs from inventory as a reduction in additional Section 263A costs, or 'negative additional Section 263A costs.'

Allocating additional Section 263A costs to EI under the simplified methods

After determining the amount of additional Section 263A costs, a taxpayer must allocate the costs between EI and COGS. The Section 263A regulations authorize three simplified methods to determine the amount of additional Section 263A costs in EI: (1) the simplified production method (SPM), (2) the simplified resale method (SRM), and, (3) under the final regulations, the modified simplified production method (MSPM).

A taxpayer that chooses not to use a simplified method must use a detailed facts and circumstances method that allocates additional Section 263A costs to units of property produced or property acquired for resale using the same degree of specificity that was required of inventoriable costs prior to the enactment of Section 263A.

The simplified methods use inventory turnover-type formulas that apply one or more 'absorption ratios' to compute the amount of additional Section 263A costs allocable to EI. Generally, a taxpayer must compute an absorption ratio for each tax year. However, a taxpayer may elect to use a historic absorption ratio (HAR), which computes an absorption ratio based on costs capitalized during a three-year 'test period,' which a taxpayer then uses during a five-year 'qualifying period.' For additional information on the HAR, see UNICAP taxpayers that claim bonus depreciation may benefit by using a historic absorption ratio.

Simplified production method

Under the formula for the SPM, additional Section 263A costs allocable to EI are the product of the absorption ratio and the amount of Section 471 costs incurred during the year that remain in EI, as follows:

$$\frac{\text{Additional Section 263A costs incurred during the tax year}}{\text{Section 471 costs incurred during the tax year}} \times \text{Section 471 costs incurred during the year that remain in EI*}$$

*A taxpayer using LIFO multiplies the absorption ratio by the LIFO layer for the year.

Modified simplified production method

The IRS and Treasury concluded that including negative amounts in additional Section 263A costs under the SPM results in significant distortions of the amounts of additional Section 263A costs and Section 471 costs allocated to ending inventory. Thus, as discussed in Final regulations provide complex rules on negative additional Section 263A costs, the final regulations generally prohibit taxpayers (except certain small taxpayers) using the SPM from including negative amounts in additional Section 263A costs. The government concluded that the use of negative amounts in the SRM does not result in the same distortions, and, therefore, taxpayers using the SRM generally may adjust additional Section 263A costs for negative amounts. The final regulations created the new MSPM, which allows large producers to include certain negative amounts in additional Section 263A costs.

The preamble to the final regulations explains that the MSPM reduces distortions by more precisely allocating additional Section 263A costs, including negative amounts, among raw materials, work-in-process (WIP), and finished goods (FG) inventories. The MSPM employs two absorption ratios: (1) a pre-production absorption ratio, which allocates 'pre-production additional Section 263A costs' to direct materials (DM) in EI; and (2) a production absorption ratio, which allocates additional Section 263A costs other than pre-production costs to WIP and FG in EI. The sum of the amounts allocated to DM, WIP, and FG in EI using the pre-production and production absorption ratios is the total additional Section 263A costs capitalized to EI.

Observation: Large taxpayers (taxpayers with average annual gross receipts over a three-year period greater than $50 million) currently using the SPM must change to the MSPM if they want to continue to include negative amounts in additional Section 263A costs. The MSPM is significantly more complex than the SPM due to the requirement to split additional Section 263A costs between pre-production and production costs. On the other hand, the MSPM could reduce capitalization of positive additional Section 263A costs to EI because production costs no longer will be allocated to in-transit or DM inventory, which is particularly favorable for taxpayers that have significant amounts of this type of inventory.

Pre-production and production costs

Pre-production costs

Pre-production additional Section 263A costs are capitalized to EI using the following formula:

$$\frac{\text{Pre-production additional Section 263A costs incurred during the tax year}}{\text{Pre-production Section 471 costs incurred during the tax year}} \times \text{Pre-production Section 471 costs remaining in EI}$$

Pre-production additional Section 263A costs (the numerator of the pre-production absorption ratio) include the following costs, if applicable, that a taxpayer incurs during its current tax year:

1. Pre-production costs described in Reg. sec. 1.263A-2(a)(3)(ii) (direct and indirect costs such as purchasing, storage and handling of DM, and other costs related to property held for future production);
2. Capitalizable mixed service costs allocable to pre-production additional Section 263A costs, discussed below;
3. Additional Section 263A costs properly allocable to property the taxpayer acquires for resale; and
4. Additional Section 263A costs properly allocable to property produced under contract for the taxpayer that is treated as property produced by the taxpayer under Reg. sec. 1.263A-2(a)(1)(ii)(B).

Pre-production Section 471 costs (the denominator of the pre-production absorption ratio) include the following costs, if applicable, that a taxpayer incurs during its current tax year:

1. DM costs defined in Reg. sec. 1.263A-1(e)(2)(i)(A) (costs 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 particular units or groups of units of property produced), including property produced under contract for the taxpayer that the taxpayer will use as DM in an additional production process;
2. Section 471 costs of property acquired for resale; and
3. Section 471 costs for property produced under contract for the taxpayer that the taxpayer acquires for resale.

Pre-production Section 471 costs remaining in EI (pre-production EI, the multiplicand of the formula) are the pre-production Section 471 costs, defined above, that remain in EI (i.e., in-transit inventory, DM, property acquired for resale, and all property produced under contract for the taxpayer that remain in the taxpayer's EI). For non-LIFO inventory, pre-production EI excludes DM costs that have entered or completed production at year-end (e.g., DM costs in WIP or FG EI). Rules for LIFO inventory are discussed below.

Production costs

Production additional Section 263A costs are capitalized to EI using the following formula:

$$\frac{\text{Production additional Section 263A costs incurred during the tax year + Residual pre-production additional Section 263A costs}}{\text{Section 471 production costs incurred during the tax year + Direct materials adjustment}} \times \text{Production Section 471 costs remaining in EI}$$

Production additional Section 263A costs (the numerator of the production absorption ratio) include the following costs, if applicable, that a taxpayer incurs during its current tax year:

1. Additional Section 263A costs that are not pre-production additional Section 263A costs, such as past service pension costs for production employees, depreciation, and property taxes for production equipment and facilities, and quality control for manufacturing activities;
2. Post-production costs described in Reg. sec. 1.263A-2(a)(3)(iii) (indirect costs incurred subsequent to completion of production that are properly allocable to property produced, such as storage and handling costs for FG); and
3. Capitalizable mixed service costs, discussed below, not allocable to pre-production additional Section 263A costs.

'Residual pre-production additional 263A costs' are the pre-production additional Section 263A costs that a taxpayer incurs during its current tax year, less the amount capitalized to pre-production EI after applying the pre-production absorption ratio.

Note: Although additional Section 263A costs not allocable to EI normally are allocated to COGS, DM costs not allocated to pre-production EI may relate to goods that have not been sold (because they are included in WIP or FG in EI). Therefore, the pre-production costs not allocated to pre-production EI are included in the production cost ratio.

Production Section 471 costs (the denominator of the production absorption ratio) are the total Section 471 costs less the pre-production Section 471 costs that a taxpayer incurs during its current tax year. In other words, production Section 471 costs are Section 471 labor and overhead costs. The 'direct materials adjustment' is determined as follows:

1. Section 471 DM costs that had not entered production at the beginning of the current tax year, including costs of property produced under contract for the taxpayer that the taxpayer will use in an additional production process;
2. Plus Section 471 direct material costs incurred during the current tax year (i.e., DM purchases);
3. Less Section 471 DM costs that have not entered production at the end of the current tax year.

Thus, the direct materials adjustment in the denominator of the ratio includes pre-production inventory in beginning inventory and DM purchased during the year, but excludes pre-production EI, which represents DM consumption during the year.

Production Section 471 costs remaining in EI (production EI, the multiplicand of the formula) are the production Section 471 costs, defined above, that remain in EI (i.e., WIP and produced FG that remain in the taxpayer's EI).

For non-LIFO inventory, production EI excludes pre-production EI. Rules for LIFO inventory are discussed below.

Pre-production and production additional Section 263A and Section 471 costs do not include indirect costs or cost reductions that a taxpayer properly allocates entirely to COGS, such as sales-based royalties.

Observation: A taxpayer currently using the SPM that changes to the MSPM must split its additional Section 263A costs between pre-production activities (e.g., design, purchasing, DM storage and handling) and production activities (e.g., manufacturing, FG storage and handling), which will require the taxpayer to perform a more detail analysis of its departments or functions.

Allocating mixed service costs to pre-production and production costs

Mixed service costs (MSC) are indirect costs of service departments or functions (e.g., general and administrative departments) that partially support production or resale (capitalizable) activities and partially support non-capitalizable (deductible) activities, such as human resources, accounting, and information technology departments.

The simplified service cost method (SSCM) uses a ratio to allocate MSC between capitalizable activities and deductible activities. A taxpayer using the MSPM with the SSCM may allocate capitalizable MSC to pre-production additional Section 263A costs based on (1) the proportion of direct material costs to total Section 471 costs that the taxpayer incurs during its current tax year, or (2) the proportion of pre-production labor costs (excluding mixed service labor costs) to total labor costs (excluding mixed service labor costs) that the taxpayer incurs during its current tax year.

A taxpayer includes capitalizable MSC not allocated to pre-production additional Section 263A costs in its production additional Section 263A costs.

A taxpayer using the MSPM and not using the SSCM for MSC generally may allocate capitalizable MSC between pre-production and production additional Section 263A costs using a reasonable method. If a taxpayer's non-SSCM method allocates capitalizable MSC to a department or activity that is exclusively identified as either pre-production or production, the taxpayer must allocate the costs solely to the respective pre-production or production additional Section 263A costs and may not allocate the costs between pre-production and production additional Section 263A costs.

Under a de minimis rule, a taxpayer may allocate 100% of capitalizable MSC to either pre-production or production additional Section 263A costs if 90% or more of the capitalizable MSC otherwise would be allocated to those costs.

Taxpayers using a LIFO method

As noted earlier, a taxpayer using a LIFO method applies a simplified method absorption ratio to the LIFO layer for the tax year. Under the final regulations, a taxpayer using the MSPM and LIFO must compute the LIFO increment (added layer) or decrement (removed layer) without regard to additional Section 263A costs.

If a taxpayer computes a LIFO increment for the tax year, the taxpayer should multiply the current-year cost (i.e., LIFO value) of the layer by a combined absorption ratio to compute the additional Section 263A costs capitalized to the layer. The combined absorption ratio is the additional Section 263A costs allocable to EI, determined on a non-LIFO basis, divided by the pre-production and production EI, determined on a non-LIFO basis.

If taxpayer computes a LIFO decrement, the additional Section 263A costs capitalized to earlier years should be charged to COGS based on the proportion of the decrement to the LIFO value of the layers that are reduced by the decrement.

Taxpayers electing the HAR

The final regulations allow taxpayers to elect the MSPM with the HAR after using the MSPM with annually computed absorption ratios for three or more consecutive years. Taxpayers using the HAR for non-LIFO inventory must apply the 0.5% test (allowing a taxpayer to extend a qualifying period if the absorption ratio computed in the first year of a new test period is within 0.5% of the HAR for the previous qualifying period) separately to the pre-production and production ratios.

The final regulations permit a taxpayer using the SPM or SRM with the HAR to revoke the HAR, including during a qualifying period, in the taxpayer's first, second, or third tax year ending on or after November 20, 2018.

Methods of accounting and method changes

Methods of accounting

The final regulations specifically identify the following provisions as methods of accounting, requiring a taxpayer to file Form 3115, Application for Change in Accounting Method, to change to the method described:

1. The alternative (AFS) method for determining the amount of Section 471 costs;
2. The de minimis rules for direct costs;
3. The safe harbor for variances and over/under-applied burden;
4. A change in financial statement practices for costs that would change the Section 471 costs for a taxpayer using a simplified method; and
5. The 90-10 de minimis rule for allocating capitalizable MSC to pre-production and production additional Section 263A costs in the MSPM.

Some of these rules are discussed in Final regulations provide complex rules on negative additional Section 263A costs.

Note: The simplified methods and the HAR election also are methods of accounting under the Section 263A regulations. However, a taxpayer makes a HAR election by filing an election statement rather than a Form 3115.

Observation: The treatment of direct costs, variances, and over/under-applied burden as Section 471 costs or additional Section 263A costs under the de minimis and safe harbor rules is not a method of accounting. Therefore, changing the treatment of these costs from Section 471 costs to additional Section 263A costs or vice versa solely as a result of applying the de minimis and safe harbor rules does not require an accounting method change.

Accounting method changes

Rev. Proc. 2018-56, effective for tax years ending on or after November 20, 2018, authorizes taxpayers to make certain changes in methods of accounting under the final regulations using the automatic procedures.

General automatic changes

Taxpayers may use the automatic procedures to change to the following methods described in the final regulations:

1. The default method for determining amounts of Section 471 costs using amounts incurred for federal income tax purposes;
2. The AFS method for determining the amount of Section 471 costs;
3. The de minimis rules for direct costs;
4. The safe harbor for variances and over/under-applied burden;
5. Removing costs from Section 471 costs as an adjustment to Section 471 costs;
6. Removing costs from Section 471 costs as a permitted negative adjustment to additional Section 263A costs;
7. The MSPM without the HAR;
8. The direct material costs and pre-production labor costs methods for allocating capitalizable MSC under the MSPM; and
9. The 90-10 de minimis rule for allocating capitalizable MSC under the MSPM.

Observation: Many taxpayers, including resellers using the SRM, currently use their financial statement costs (types and amounts) to determine their Section 471 costs. Generally, these taxpayers may continue to use this method if they are (1) eligible to use the AFS method; (2) already treating all direct costs as Section 471 costs, or they are permitted to treat excluded direct costs as additional Section 263A costs under the de minimis rules; (3) already treating variances or over/under-applied burden as Section 471 costs, or they are permitted to treat excluded variances or over/under-applied burden as additional Section 263A costs under the safe harbor rule; and (4) already treating cash or trade discounts as Section 471 costs, or they are permitted to treat excluded cash or trade discounts as additional Section 263A costs under the de minimis or safe harbor rules. However, taxpayers will have to file a Form 3115 to change to the AFS method and to the de minimis and/or safe harbor rules, even though their present methods are consistent with these rules, in order to continue to treat these costs as additional Section 263A costs (provided these costs qualify under the applicable rules).

Rev. Proc. 2018-56 also authorizes taxpayers using or changing to a simplified method to use the automatic method change procedures to recharacterize Section 471 costs as additional Section 263A costs or vice versa, as required by the final regulations, with the following terms and conditions:

1. If a taxpayer is required to restate its financial statement for prior years and the taxpayer determined its Section 471 costs based on its financial statement for those years, the taxpayer is treated as using a proper method of accounting for Section 471 costs and is not required to change its determination of Section 471 costs;
2. A taxpayer may make this change by completing only certain lines on Form 3115; and
3. A taxpayer making this change that uses the HAR must revise all prior calculations for the original test period, recomputation years, and all updated test periods to compute the Section 481(a) adjustment.

Observation: The requirement that taxpayers using the HAR must revise all prior calculations to compute the Section 481(a) adjustment when recharacterizing costs in accordance with the final regulations is extremely burdensome. In addition, the final regulations and method change procedures do not allow taxpayers to change from the SPM with the HAR to the MSPM with the HAR. Thus, virtually all large taxpayers using the SPM with the HAR will want to revoke their HAR election or change to the MSPM without the HAR.

Transition rules for HAR

Rev. Proc. 2018-56 allows taxpayers to make the following accounting method changes using the automatic procedures only for a taxpayer's first, second, or third tax year ending on or after November 20, 2018:

1. From a simplified method with the HAR to either (a) a different simplified method without the HAR, or (b) a specific identification, burden rate, or standard cost method;
2. From the SPM or SRM with the HAR to the same simplified method without the HAR (revocation of HAR election).

A taxpayer changing from the SPM or SRM with the HAR to the same method without the HAR makes the change on a cut-off basis (with no Section 481(a) adjustment). If the change is for a tax year in a qualifying period, the taxpayer will not receive audit protection.

Other terms and conditions

For changes in a taxpayer's first, second, or third tax year ending on or after November 20, 2018, Rev. Proc. 2018-56 waives the rule preventing a taxpayer from using the automatic procedures more than once in a five-year period for a change in the same method of accounting.

Taxpayers making a change under Rev. Proc. 2018-56 and another automatic change under Section 263A for the same tax year generally may make the changes on one Form 3115.

Observation: Generally, a taxpayer that files an accounting method change under Rev. Proc. 2018-56 receives audit protection for prior tax years, as provided in Rev. Proc. 2015-13. Thus, when a taxpayer files a Form 3115, the IRS will not require the taxpayer to change its method of accounting for the same item for a tax year prior to the requested year of change. For a taxpayer currently using improper methods that have resulted in capitalizing fewer costs than required under Section 263A, filing a Form 3115 to obtain audit protection would prevent the IRS from increasing taxable income in years when tax rates were higher before the 2017 tax reform legislation.

The takeaway

Most large taxpayers using the SPM will want to change to the new MSPM under the final regulations. The MSPM is much more complex than the SPM, but not nearly as complex as making negative adjustments to Section 471 costs, which would be required for large taxpayers that continue to use the SPM.

All taxpayers should evaluate whether to file additional accounting method changes to implement methods permitted or required under the final regulations, including changes to the alternative (AFS) method for determining Section 471 costs, the de minimis rules for direct costs, the safe harbor for variances and over/under-applied burden, the methods for allocating capitalizable MSC under the MSPM, and to revoke the HAR election.

Let's talk

For a deeper discussion of how these regulations might affect your business, please contact one of the PwC professionals listed below, or your local Accounting Method Services contact:

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