

Part III - Administrative, Procedural, and Miscellaneous

Request for Comments and Interim Guidance Regarding Allocation of Costs under the Simplified Methods of Accounting under § 263A

Notice 2007-29

The Internal Revenue Service and Treasury Department are studying the appropriateness of the use of negative amounts in computing additional costs for purposes of the simplified methods of accounting under § 263A of the Internal Revenue Code. This notice invites public comment on changes to the simplified production method under § 1.263A-2(b) and the simplified resale method under § 1.263A-3(d) of the Income Tax Regulations. This notice also provides interim guidance pending the publication of future guidance.

BACKGROUND

Section 471 provides the general rules for inventories and authorizes the Secretary to determine when the use of inventories are necessary to clearly reflect income and to determine the valuation methods that are acceptable for tax purposes. The regulations under § 471 provide the general rules for the valuation of inventories.

Section 263A was enacted under the Tax Reform Act of 1986, and prescribes uniform capitalization rules for property produced or held for resale. Under § 263A, producers of real or tangible personal property and resellers of real or personal property must capitalize the direct costs and a proper share of the indirect costs of the property. Section 263A requires capitalization of indirect costs but generally does not set forth

methods for allocating indirect costs. Instead, in accordance with the legislative history, the regulations under § 263A generally provide that taxpayers must allocate indirect costs to property using detailed or specific cost allocation methods, including a specific identification method, the standard cost method, and methods using burden rates. Alternatively, taxpayers may use the simplified production method or simplified resale method (simplified methods), as applicable.

The legislative history to § 263A indicates that Congress desired the Service to adopt a flexible approach in the § 263A regulations by providing simplified methods and assumptions when the costs and burdens of compliance may outweigh the benefits. Accordingly, the simplified methods are intended to alleviate the administrative burden of complying with the capitalization rules of § 263A.

In general, the simplified methods determine aggregate amounts of additional § 263A costs allocable to ending inventory. Additional § 263A costs generally are those costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of § 263A, but that are required to be capitalized under § 263A. Under the simplified methods, additional § 263A costs allocable to ending inventory are determined by multiplying § 471 costs (generally, the costs other than interest the taxpayer capitalized under its method of accounting immediately prior to the effective date of § 263A) remaining on hand at year end by an absorption ratio consisting of a numerator of additional § 263A costs incurred during the taxable year over a denominator of § 471 costs incurred during the taxable year.

At the time the § 263A regulations were issued, some commentators expressed concern that the simplified methods, in particular the simplified production method,

would result in allocation of an excessive amount of § 263A costs to raw materials inventories. They suggested that this result occurs because the simplified production method does not take into account the fact that fewer indirect costs are incurred with respect to raw materials that are normally held only a short period of time, compared to other items of inventory held longer. The final regulations did not adopt these recommendations because the simplified production method formula properly reflects the costs of raw materials that are purchased on the last day of the year, and incorporating the suggestions would have reduced the simplicity that the simplified production method was intended to provide.

More recently, controversy has arisen regarding the inclusion of negative amounts in additional § 263A costs and whether aggregate additional § 263A costs may be a negative number. A negative amount may occur, for example, when a taxpayer includes book costs greater than those required for tax purposes in the § 471 cost of inventory. For example, if a taxpayer included book depreciation in § 471 costs in accordance with § 1.471-11(c)(2)(iii)(b) and the book depreciation is greater than tax depreciation for the year, the taxpayer may have capitalized too much depreciation for purposes of § 263A and must reduce total § 263A costs by the excess. A negative amount may result if the taxpayer does not adjust its § 471 costs to remove this excess depreciation amount but instead makes a negative adjustment to its additional § 263A costs. Some taxpayers have reasoned that allowing negative amounts is consistent with the purpose of the simplified methods to alleviate the administrative burden of complying with the capitalization rules of § 263A and may reduce overcapitalization that sometimes results.

The Service and Treasury Department are aware of this viewpoint but are concerned that including negative amounts in additional § 263A costs may result in significant distortions in some situations. Including negative amounts in additional § 263A costs may undercapitalize amounts because the simplified production method formula may remove more of the cost from ending inventory than was actually remaining in ending inventory. Generally, this distortion is caused by the use of a different formula for removing the cost from ending inventory than the formula by which the cost was originally capitalized under § 471. The inclusion of raw materials in the simplified production method formula also may cause distortions. For example, including a negative amount for book depreciation greater than tax depreciation (excess depreciation) in the simplified production method formula may reduce ending inventory by more than the amount of excess depreciation actually remaining in ending inventory. In some circumstances this distortion may be a reversal of the overcapitalization of excess tax depreciation over book depreciation in prior years, and thus, may not be a cause for concern. However, the inclusion can cause significant, lasting distortion in situations in which the taxpayer has a tax basis much lower than book basis in depreciable property.

The Service and Treasury Department are considering amending the regulations under § 263A to prohibit the use of some or all negative amounts in computing additional § 263A costs under the existing simplified methods and to provide a new alternative simplified method of cost allocation under § 263A. The Service and Treasury Department will consider a new method that would allow negative amounts in computing additional § 263A costs, avoid requiring changes to existing systems for

determining § 471 costs, but reduce distortions. One option under consideration would treat costs related to raw materials differently from those related to work-in-process or finished goods. Another option would create distinctions based upon the type of cost, with certain permanent items such as basis differences being allocated using a separate formula. Additionally, the Service and Treasury Department are considering whether special rules should be provided for smaller taxpayers to compute additional § 263A costs.

INTERIM GUIDANCE

Pending the issuance of additional published guidance, the Service will not challenge the inclusion of negative amounts in computing additional costs under § 263A or the permissibility of aggregate negative additional § 263A costs. These issues will not be raised in any taxable year ending on or before publication of the guidance, and, if already raised as an issue in examination or before Appeals or the Tax Court in a taxable year ending on or before March 12, 2007, the issue will not be pursued by the Service. In addition, pending further published guidance, the Service will not deny consent for changes in method of accounting solely on the basis that the proposed method involves the inclusion of negative amounts in computing additional costs under § 263A or the permissibility of aggregate negative additional § 263A costs. However, the Service will not grant a taxpayer permission to treat a cost as a negative additional § 263A cost unless the taxpayer already treats that cost as a § 471 cost. In other words, the Service will not approve a change in method of accounting to change the costs capitalized under § 471 to begin capitalizing a cost under § 471 and to remove the same cost from ending inventory by treating it as a negative additional § 263A cost. In

addition, any taxpayers granted consent to make these changes will be required to conform their methods of accounting to any future published guidance.

REQUEST FOR COMMENTS

The Service and Treasury Department specifically request public comments on the following issues:

1. If only some negative amounts are appropriate in computing additional § 263A costs under the existing simplified methods, which costs should be allowed and under what circumstances? For example, should variances that were treated as top-side adjustments (aggregate adjustments to total ending inventory that are not allocated to each item or unit in ending inventory) before enactment of § 263A be treated differently from variances that first arose after enactment of § 263A? If negative amounts may be included in the numerator of the existing methods for some costs, should aggregate negative additional § 263A costs be prohibited or restricted? Should items that generate a permanent difference, such as basis differences, be allowed under the existing simplified methods, or should they be allocated using a different method?
2. If the use of negative amounts is restricted for certain costs or in certain situations as described in (1) above, what specific modifications should be made to the existing simplified methods to effect this result and how should the negative costs be allocated? Should a new, alternative simplified method be created to allocate the negative costs or all additional § 263A costs?
3. How might a new, alternative simplified method of allocating costs under § 263A be designed that could be used for all additional § 263A costs, positive or negative, in lieu of the existing simplified methods, that would treat costs related to raw materials

(including raw material content of work-in-process and finished goods) differently from those related to work-in-process or finished goods (excluding raw material content) and achieve maximum simplicity while reducing distortions? In particular, comments are requested on (a) how costs, including variances and book-tax differences, should be allocated between raw materials, work-in-process and finished goods, (b) whether only purchasing costs should be allocated to raw materials, (c) whether purchasing, storage, and handling costs of raw materials should be allocated to raw materials, (d) whether § 471 costs should be adjusted for purchased raw materials in transit and beginning inventory, and (e) whether separate absorption ratios should be calculated for raw materials, work-in-process and finished goods, and, if so, how those ratios should be calculated.

4. Should the simplified methods be modified for small taxpayers and if so, how? In particular, how should any changes described above be applied to small taxpayers? What criteria should be used for determining whether a taxpayer is a small taxpayer?

Comments should be submitted in writing on or before July 2, 2007, and should include a reference to Notice 2007-29. Send submissions to: CC:PA:LDP:PR (Notice 2007-29), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (Notice 2007-29), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue N.W., Washington, DC. Alternatively, comments may be submitted electronically directly to the Service via the following e-mail address: Notice.comments@irs.counsel.treas.gov. Please include

“Notice 2007-29” in the subject line of any electronic communication. All materials submitted will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is W. Thomas McElroy, Jr. of the Office of the Associate Chief Counsel (Income Tax and Accounting). For further information concerning this notice, contact Mr. McElroy at (202) 622-4970 (not a toll-free number).