ABA Tax Accounting
January 2018
Inventory – Hot Topics
Final 263A Regulations

• Background

  – Section 263A requires taxpayers to capitalize all direct costs and certain indirect costs related to production or resale activities

  – When a taxpayer determines the costs required to be capitalized under Section 263A, taxpayers typically start with the types and amounts of costs capitalized for financial statements and then make the adjustments required by Section 263A.

  – Generally Section 263A requires taxpayers to capitalize additional costs to inventory

  – However, taxpayers may have capitalized costs for financial purposes that are not permitted to be capitalized for tax purposes

  – Financial statements may overcapitalize costs relative to tax due to differing types or amounts (e.g., due to book-tax differences) of costs required to be capitalized

  – Many taxpayers using the simplified production method and simplified resale method have historically considered “negative additional section 263A costs” in applying those methods

  – IRS National Office and Exam questioned the propriety of negative additional section 263A costs

  – Notice 2007-29 – Placed moratorium on IRS Exam activity pending further guidance

  – Proposed Regulations were issued in 2012

  – Final Regulations were issued on November 20, 2018
Final Section 263A Regulations

• Generally prohibit use of negative additional section 263A costs unless:
  – Taxpayer is a small taxpayer with three-year annual gross receipts of $50 million or less, or
  – Taxpayer uses the simplified resale method, or
  – Taxpayer uses modified simplified production method

• Provides new definition of Section 471 costs
Final Section 263A Regulations
Modified Simplified Production Method

• Under MSPM additional 263A costs capitalized to eligible property (inventory and certain self-constructed assets) equals:

  (Pre-production absorption ratio * Pre-production section 471 costs remaining on hand)

  Plus

  (Production absorption ratio * Production 471 costs remaining on hand at year end)
Final Section 263A Regulations
Modified Simplified Production Method

• Pre-production ratio equals:

  Current year pre-production additional section 263A costs
  Current year pre-production section 471 costs

• Pre-production additional section 263A costs are:
  – Additional section 263A costs related to pre-production costs
  – Additional section 263A costs allocable to resale property
  – Additional section 263A costs allocable to property produced under contract

• Pre-production section 471 costs are:
  – Direct material costs
  – Cost of property acquired for resale
  – Cost of property produced for taxpayer under contract
Final Section 263A Regulations
Modified Simplified Production Method

- Production absorption ratio equals:

\[
\text{Production additional section 263A costs} + \text{Residual pre-production additional section 263A costs} \\
\text{Production section 471 costs} + \text{Direct materials adjustment}
\]
Final Section 263A Regulations
Modified Simplified Production Method

• Production additional costs are additional section 263A costs that are not pre-production section 263A costs

• Residual pre-production additional section 263A costs equals:

\[
\text{current year pre-production additional section 263A costs} - \left( \text{Pre-production absorption ratio} \times \text{Pre-production section 471 costs remaining on hand at year end} \right)
\]

• Production section 471 costs are current-year section 471 costs less current-year pre-production section 471 costs

• Direct materials adjustment is:

\[
\text{Pre-production section 471 costs at beginning of year} + \text{Current year direct material purchases} - \text{Section 471 direct material costs not in production at year end}
\]
Final Section 263A Regulations
Modified Simplified Production Method

• Taxpayers do not need to track direct material costs contained in WIP and finished goods.

• Capitalized mixed service costs allocated between pre-production and production ratios.
  – If taxpayer uses simplified service cost method, capitalizable mixed service costs allocated based on either:
    • Direct material purchases
    • Labor costs
  – Taxpayers not using simplified service cost method may allocate capitalizable mixed service costs using reasonable method.
  – De minimis rule (90/10 rule) can also be used.

• Amounts used to compute combined ratio for LIFO is computed on non-LIFO basis.

• Cash and trade discounts generally cannot be allocated as additional 263A costs unless de minimis rule applies.

• Certain variances that are not capitalized for financial statements may be allocated as additional Section 263A under safe harbor rule.
Final Section 263A Regulations
Definition of Section 471 costs

• Section 471 costs are generally the *types* of costs capitalized for financial statements.

• Section 471 costs generally must include all direct costs (both the types and amounts).

• Alternative method permits *amounts* of Section 471 costs to be based on taxpayer’s applicable financial statement (AFS).

• De minimis exception for certain direct costs.
Final Section 263A Regulations
Revenue Procedure 2018-56

• Provides automatic consent to make to comply with new final regulations, including:
  – Change to comply with new definition of Section 471 costs
  – Change from simplified method with HAR to other simplified method without HAR
  – Expands the list of UNICAP methods specifically provided by the regulations to allow automatic changes.
  – Scope waiver
Final Section 263A Regulations

Questions/Issues
Other Current Developments

• Cases

• Guidance
  – LTR 20184801 – Additional 263A costs capitalized to ending inventory equals product of current year absorption and Section 471 costs remaining on hand at year end even if portion of beginning inventory remains in ending inventory. Additional costs capitalized to beginning inventory are recovered through cost of goods sold.
  – LTR 201836005 – IRS ruled that gross pension plan asset valuation in notes to consolidated financial statements was supplemental and explanatory information for 30 percent foreign operating asset test provided by Rev. Rul 78-246.
  – Status of LIFO pooling regulations?
  – Changes made by TCJA for small taxpayers