Proposed regulations prohibit negative amounts under simplified methods of accounting; provide new modified simplified production method

September 4, 2012 | No. 2012-411

The Treasury Department and IRS today released for publication in the *Federal Register* proposed regulations (REG-126770-06) generally prohibiting the use of negative amounts in computing additional costs for purposes of the simplified methods of accounting under section 263A (subject to certain exceptions).

The proposed regulations also provide a new modified simplified production method for use by producers. This new method is intended to reduce distortions that currently are found under the traditionally simplified methods, by more precisely allocating additional section 263A costs—including negative amounts—among raw materials, work-in-process, and finished goods inventories.

Finally, these proposed regulations adopt a single definition of section 471 costs that applies to taxpayers that were in existence before the effective date of section 263A and to newer taxpayers—whether using the simplified production method, the modified simplified production method, or the simplified resale method.

Today's proposed regulations were anticipated by an IRS notice (issued in early 2007). Notice 2007-29 provided interim guidance pending the publication of these regulations.

Notice 2007-29 is to be superseded as of the date these proposed regulations are published as final regulations in the *Federal Register*, and the proposed regulations will apply to tax years ending on or after this date of final regulations publication. Thus, the proposed regulations are not yet effective, and existing authorities continue to govern section 263A methods and method changes for now.

Background

In 2007, in order to address situations in which taxpayers were including negative amounts as additional section 263A costs and also in which aggregate additional section 263A costs were a negative number, the IRS issued Notice 2007-29 which announced that Treasury and the IRS were considering changes

to the regulations under section 263A:

- To prohibit the use of some or all negative amounts in computing additional section 263A costs under the existing simplified methods
- To provide a new alternative simplified method of cost allocation under section 263A

Also, it was indicated that a new method might allow negative amounts in computing additional section 263A costs, which would avoid requiring changes to existing systems for determining costs, but would reduce distortions. The new method was proposed as one of two options: (1) one option would treat costs related to raw materials differently from those related to work-in-process or finished goods; (2) another would create distinctions based upon the type of cost, with certain permanent items such as basis differences being allocated using a separate formula.

Notice 2007-29 included a request for comments.

Proposed regulations

Today's proposed regulations generally address three areas:

- A prohibition on negative amounts
- A new modified simplified production method
- A simplified definition of section 471 costs and elimination of separate provisions for new taxpayers

Negative amounts prohibited

To reduce the distortions that occur by including negative amounts under the simplified methods, the proposed regulations generally provide that, subject to certain exceptions, taxpayers may not include negative amounts in additional section 263A costs.

KPMG observation

If finalized as drafted, these provisions would appear to restrict not only removal of costs that are capitalized for book purposes but also reflection of unfavorable book-tax differences (depreciation being among the most common).

Treasury and the IRS have requested comments concerning:

- Transition rules for those taxpayers currently using the simplified production method with the historic absorption ratio election (Reg. section 1.263A-2(b)(4))
- How the regulations are to apply to taxpayers that are part way through the qualifying period as described in Reg. section 1.263A-2(b)(4)(ii)(C).

To reduce the administrative burden for “smaller” taxpayers, the proposed regulations allow producers with average annual gross receipts of $10 million or less to include negative amounts in additional section 263A costs under the simplified production method.

Also, as noted in the preamble, because negative additional section 263A costs cause less distortion under the simplified resale method than under the simplified production method, the proposed regulations allow taxpayers using the simplified resale method to remove section 471 costs that are not required to be capitalized for tax purposes from ending inventory by treating them as negative additional section 263A costs.

The proposed regulations generally prohibit treating cash or trade discounts (Reg. section 1.471-3(b)) as negative amounts under any of the simplified methods. Treasury and the IRS have requested comments on “reasonable methods” of allocating between ending inventory and cost of goods sold cash or trade discounts that taxpayers do not capitalize for book purposes (and therefore are not section 471 costs within the meaning of Reg. section 1.263A-1(d)(2)).

New modified simplified production method

The proposed regulations—reflecting comments made in response to Notice 2007-29—provide a new modified simplified production method that reduces the distortions that exist under the traditional simplified methods by more precisely allocating additional section 263A costs, including negative amounts, among raw materials, work-in-process, and finished goods inventories.

Under the modified simplified production method, producers determine the allocable portion of preproduction related additional section 263A costs (such as storage and handling for raw materials) using a preproduction cost absorption ratio. The preproduction cost absorption ratio is applied to raw material section 471 costs incurred during the tax year and remaining on hand at year-end.

For purposes of computing the allocable portion of preproduction related additional section 263A costs, raw material costs on hand at year-end include: (1) unprocessed raw materials; and (2) raw materials that are integrated into work-in-progress and finished goods.

Under the modified simplified production method, producers determine the allocable portion of all other additional section 263A costs using a production cost absorption ratio.

In addition to reducing distortions that exist under the simplified production method by more precisely allocating additional section 263A costs to raw materials, the modified simplified production method would provide a method to remove section 471 costs that are not required to be capitalized for tax purposes from ending inventory by treating them as negative additional section 263A costs. Still, resellers and producers are allowed to use methods that more precisely allocate additional section 263A costs while alleviating administrative burden, consistent with the purpose of the simplified methods.

Like other simplified methods, a taxpayer must maintain adequate records substantiating proper use of the modified simplified production method.

Treasury and the IRS have requested comments on the modified simplified production method, including:

- Whether distortions will occur if preproduction related additional section 263A costs are not directly traced from raw materials through work-in-process and finished goods inventories from year to year
- How mixed service costs are to be allocated between raw materials, work-in-process, and finished goods inventories under the new formula
- How the new formula is to apply to a taxpayer using the last-in, first-out (LIFO) method of accounting

Simplified definition of section 471 costs and elimination of separate provisions for new taxpayers

The proposed regulations adopt a single definition of section 471 costs that applies to taxpayers that were in existence before the effective date of section 263A and to newer taxpayers—whether using the simplified production method, the modified simplified production method, or the simplified resale method.

The proposed regulations provide that, for purposes of the simplified methods, a taxpayer's section 471 costs, in general, are the costs, other than interest, that a taxpayer capitalizes to its inventory in its financial statements. However, a taxpayer must include all direct costs in its section 471 costs regardless of the taxpayer's treatment of the costs in its financial statements.

The proposed regulations:

- Require a taxpayer that is not permitted to remove section 471 costs as negative additional section 263A costs to reduce its section 471 costs
- Provide that a taxpayer that reduces its section 471 costs must use a reasonable method that approximates the manner in which the taxpayer originally capitalized the costs.

REG-126770-06 will be published in the *Federal Register* on Wednesday, September 5, 2012.

* * * * *

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY KPMG TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

Back to top

Direct comments, including requests for subscriptions, to US-KPMGWNT@kpmg.com. For more information, contact KPMG's Federal Tax Legislative and Regulatory Services Group at + 1 202.533.4366, 1801 K Street, NW, Washington, DC 20006.