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An Analysis of the Impact of the New UNICAP
Regulations



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Background

1. After evaluating the operation of the simplified production method (“SPM”) for a number of years, the IRS reached the conclusion that the allocation formula that was contained in the SPM had the potential to create distortions in computing the cost of a taxpayer’s inventory.
 - a. In some cases, the SPM over-allocates additional § 263A costs to a taxpayer’s ending inventory in comparison to a facts-and-circumstances allocation method.
 - b. In other cases, the SPM under-allocates additional § 263A costs to a taxpayer’s ending inventory.

2. In the light of the foregoing conclusions, the Treasury and IRS issued proposed regulations several years ago that provided a new modified and simplified production method (“MSPM”) to correct the distortions that the IRS perceived were present under the SPM.
 - a. The preamble to those proposed regulations also alluded to various issues with respect to the classification of additional § 263A costs that might more properly be regarded as components of direct costs (i.e., direct material costs or direct labor costs).
 - b. However, no explicit guidance was provided on that issue.

3. In response to the proposed regulations, numerous criticisms were received by the IRS and Treasury concerning the operation of the original proposed version of the MSPM.
 - a. Complaints were registered regarding the vague guidance in the preamble concerning costs that might be classified as direct costs.
 - b. In addition, there were complaints that data was not available to calculate the appropriate burden rates under the new MSPM because of the need to split out the raw material content of work-in-process, finished goods from labor, overhead costs, and allocate that raw material content together with raw materials.

4. Accordingly on November 19, 2018, new final regulations were issued.
 - a. These regulations contain a revised version of that MSPM.
 - b. However, these final regulations also contain detailed, and in some respects, extremely burdensome new rules for determining the starting point for all of the simplified allocation methods, including the new MSPM.
5. These new regulations are generally effective for the 2019 taxable year, but a taxpayer may optionally apply the new regulations to any taxable year beginning before November 20, 2018 and ending after that date (i.e., 2018 calendar taxable years).

The Starting Point for Tax UNICAP Calculations

1. The starting point for SPM and MSPM calculations is the inventory method that is presently used for financial reporting purposes. The general rules are that the starting point for the calculations under the SPM or MSPM, which is described as a taxpayer's "§ 471 costs," are based on the *types* of costs included in the inventoriable costs for financial reporting purposes. Treas. Reg. § 1.263A-1(d)(2)(i).

2. To treat a taxpayer's § 471 costs as taking into account the *amount* of costs included in the inventoriable costs in their financial statements, they must also elect to use the new so-called "alternative method." Treas. Reg. § 1.263A-1(d)(iii).
 - a. If a taxpayer's financial statements are subject to audit by independent certified public accountants, they must elect to use the MSPM in order to be able to treat both the *types* of costs and the *amounts* of costs included in the inventoriable costs for financial reporting purposes as their § 471 costs. Treas. Reg. § 1.263A-1(d)(2)(iii)(A).
 - b. However, certain small taxpayers may elect the alternative method without electing the MSPM.
3. Question- Why did the IRS adopt this complex regime? Why not simply adopt the rule that except for certain small taxpayers, a taxpayer must elect the MSPM to get the benefit of using the *amount* of the inventoriable costs included in their financial statements as its § 471 costs?

Exceptions to the § 471 Cost Starting Point

1. Even if a taxpayer elects the alternative method, modifications may need to be made to the starting point for a taxpayer's UNICAP allocation system in three areas.
2. Before addressing the exceptions to this requirement, several questions are posed...
 - a. Question- Why didn't the IRS simply adopt the AICPA suggestion that the amount of a taxpayer's inventoriable costs in financial statements is the starting point for the SPM and MSPM, and any costs excluded from the inventoriable costs for financial reporting purposes, whether direct or indirect, may be treated as an additional § 263A cost?

- b. Question- If a taxpayer is required to treat a component of direct costs that has been excluded from the inventoriable costs for financial reporting purposes as a § 471 cost, what degree of specificity is required as part of such treatment? Must the taxpayer carry the allocation of such a cost down to the level of the unit cost of each individual item in the taxpayer's inventory?
- c. Question- In the past, the IRS has been concerned about taxpayers that included direct costs in the inventoriable costs for financial reporting purposes, but treated such direct costs as indirect costs. TAM 200437006. The new final regulations appear to allow such treatment, as all of the restrictions on reclassifying direct costs as § 471 costs appear to relate to costs that are entirely excluded from the inventoriable costs for financial reporting purposes. As a result, a taxpayer treating a direct costs as an indirect cost for financial reporting purposes, but nevertheless including the cost in the inventoriable costs need not reclassify that cost as a direct cost. Is that correct?

3. Turning to the exceptions from treating all the inventoriable costs for financial reporting purposes as additional § 263A costs that are either:
 - a. Costs that should be included in direct material costs.
 - b. Costs that should be included in direct labor costs.
 - c. Standard cost variances or unabsorbed burden, in an allocation system where a burden rate method is used.
4. These exceptions apply to taxpayers using either SPM, MSPM, or the SRM.

5. Exception One for a direct material costs:

- a. If a taxpayer excludes a component of direct material costs, such as freight-in or cash or trade discounts, from the inventoriable costs for financial reporting purposes, such a taxpayer may be required to treat those direct material costs as an adjustment to their § 471 costs, rather than as an additional or negative additional, § 263A cost, unless the taxpayer satisfies a de minimis test in the regulations. Treas. Reg. § § 1.263A-1(d)(2)(II)(A) & (B).
- b. This requirement applies even to a taxpayer that uses the alternative method.
- c. However, if the taxpayer uses the alternative method, this requirement does not apply to a Schedule M adjustment with respect to the amount of a direct material cost, so that if the book amount of the component of direct material costs is included in the inventoriable costs for financial reporting purposes, a Schedule M adjustment for the amount of that cost may be treated as an additional § 263A cost, regardless of the de minimis test.

- d. Question- Why do the regulations separate the treatment of book amounts from tax amounts, once it has been determined that a direct cost has been excluded from the inventoriable costs for financial reporting purposes?
- e. To apply the de minimis test, the taxpayer must compute a ratio, the numerator of which is the amount of direct material cost components that are excluded from the inventoriable costs (computed on a book basis and by aggregating positive and negative amounts) and the denominator of which is the total amount of raw materials' costs incurred (computed on a book basis). Treas. Reg. § 1.263A-1(d)(2)(iv)(C).
- f. If the ratio is less than 5%, the taxpayer may treat the excluded direct material costs as additional § 263A costs.
- g. If the ratio equals or exceeds 5%, the taxpayer must treat the book amount of the excluded direct material costs as an adjustment to § 471 costs, rather than as an additional § 263A cost.
- h. Question- Why are positive and negative amounts netted in this test?

6. Exception Two for direct labor costs:

- a. If a taxpayer excludes a component of direct labor costs, such as vacation pay or other types of fringe benefits, from the inventoriable costs for financial reporting purposes, such taxpayer may be required to treat those direct labor costs as an adjustment to the taxpayer's § 471 costs, rather than as an additional or negative additional § 263A cost, unless the taxpayer satisfies a de minimis test in the regulations.
- b. As in the case of direct material costs, this requirement applies even though the taxpayer uses the alternative method.
- c. However, as in the case of direct material costs, if the taxpayer uses the alternative method, this requirement does not apply to a Schedule M adjustment with respect to the amount of a direct labor cost. Accordingly, if the book amount of the component of direct labor costs is included in the inventoriable costs for financial reporting purposes, a Schedule M adjustment with respect to the amount of that cost may be treated as an additional § 263A cost, regardless of whether the de minimis test is satisfied.

- d. To apply the de minimis test, the taxpayer must compute a ratio, the numerator of which is the amount of direct labor components excluded from inventory (computed on a book basis) and the denominator of which is the total amount of raw labor costs incurred (computed on a book basis). Treas. Reg. § 1.263A-1(d)(2)(iv)(B).
- e. If the ratio is less than 5%, the taxpayer may treat the excluded direct labor costs as additional § 263A costs.
- f. If the ratio equals or exceeds 5%, the taxpayer must treat the book amount of the excluded direct labor costs as an adjustment to § 471 costs, rather than an additional § 263A cost.
- g. Question- Why are basic compensation and overtime excluded from the de minimis test?

7. Exception Three for standard cost variances:
 - a. If a taxpayer excludes variances from the inventoriable costs for financial reporting purposes, such taxpayer may be required to treat those variances as an adjustment to their § 471 costs, rather than as an additional or negative additional § 263A cost, unless they satisfy a safe harbor test in the regulations.
 - b. As in the case of direct material and direct labor costs, this requirement applies even if the taxpayer uses the alternative method.
 - c. To apply the safe harbor test, the taxpayer must compute a ratio, the numerator of which is the total amount of variances excluded from the inventory (computed on a book basis and with positive and negative amounts aggregated without regard to their sign) and the denominator of which is the total amount of production costs incurred during the taxable year. Treas. Reg. § 1.263A-1(d)(2)(v).

- d. If the ratio is less than 5%, the taxpayer may treat the excluded variances as an adjustment to § 471 costs, rather than an additional § 263A cost.
- e. If the ratio equals or exceeds 5%, the taxpayer must treat the excluded variances as an adjustment to § 471 costs, rather than an additional § 263A cost.
- f. Question- The same question is posed here as in the case of direct material costs. Why are the positive and negative variances netted?
- g. Question- May positive and negative variances still be netted in determining whether the variances are significant in amount under the rules in Treas. Reg. § 1.263A-1(e)(4)(ii)(B) that determines whether the variances need to be taken into account at all as the inventoriable costs for tax purposes?

Treatment of Negative Additional § 263A Costs

1. The main impetus for this regulations project was the IRS' concern regarding taxpayers using the SPM that had negative additional § 263A costs.
2. The new final regulations address this issue in a manner that differs from the proposed regulations.
3. The final regulations distinguish between a negative additional § 263A cost resulting from a book/ tax difference that relates merely to a difference in the *amount* in a particular cost category for book and tax purposes and a book/ tax difference that relates to a difference in the inventory treatment of an *entire category* of cost.

4. Negative adjustments resulting from Schedule M adjustments relating to the amount of an inventoriable may be removed from inventory as a negative additional § 263A costs.
5. However, adjustments resulting from Schedule M adjustments relating to the exclusion of an entire category of § 471 costs from the inventoriable costs for tax purposes may be treated as negative additional § 263A costs only if the taxpayer uses the MSPM and the alternative method.
6. Question- Why do the regulations draw this distinction between negative amounts of additional § 263A costs and entire categories of negative additional § 263A costs?

Computation of Allocation Ratio

New Absorption Ratio

1. Under the new regulations, a new version of the MSPM has been adopted with a new allocation or absorption ratio.
 - a. Under the MSPM in the final regulations, the single SPM absorption ratio that was contained in the original UNICAP regulations has been divided into two separate components: (1) One absorption ratio for additional § 263A costs that relate to the period of time before production of products begins, when raw material items are still in their unprocessed state, and (2) A second absorption ratio for all other additional § 263A costs, regardless of when the costs are incurred.

2. Under MSPM, the pre-production absorption ratio is the amount of pre-production additional § 263A costs and the denominator is the amount of pre-production § 471 costs. The ratio is multiplied by the ending § 471 cost of raw materials in ending inventory. Treas. Reg. §§ 1.263A-2(c)(3)(i)(A) & (B).
3. Under MSPM, the numerator of the production absorption ratio includes the amount of production additional § 263A costs, as well as the residual amount of pre-production additional § 263A costs that are not allocated to the ending inventory of unprocessed raw materials under the pre-production absorption ratio.
4. Likewise, the denominator of the production absorption ratio is modified, so that it includes an adjustment for the portion of § 471 costs that are direct material costs that had not entered the production process at the beginning of the taxable year, plus the portion of § 471 costs that are direct material costs that are incurred during the taxable year (purchases), unless the portion of § 471 costs that are direct material costs that have not entered into the production process at the end of the taxable year.

5. Does the IRS want to comment on why it adopted this approach?
6. The production cost ratio is multiplied by the § 471 cost of the taxpayer's ending work-in-process and finished goods inventory to obtain the § 263A amount that is added on to the § 471 cost of the taxpayer's ending inventory of work-in-process and finished goods.
7. For taxpayers using the LIFO method for raw materials, work-in-process and finished goods inventories, the regulations require that the two absorption ratios be combined, and the combined ratio is multiplied by the § 471 cost of any LIFO increment that is added to the ending inventory for the taxable year.

Computation of Allocation Ratio: Cont'd

Treatment of Mixed Service Costs

1. One of the categories of costs that is typically treated as additional § 263A costs by most taxpayers is mixed service costs, namely general and administrative types of costs.
 - a. One of the complexities introduced in the computation of the absorption ratios under the MSPM in the proposed regulations was the need to allocate mixed service costs between pre-production additional § 263A costs and production additional § 263A costs in order to subject mixed service costs to the different absorption ratios that were applied to raw materials and work-in-process and finished goods.

2. The new regulations offer a new de minimis test as a way of avoiding the need for such an inclusion of mixed service costs in pre-production additional § 263A costs.
 - a. For taxpayers using the simplified service cost method, if 90% or more of mixed service costs would be allocable to production costs, then the taxpayer may allocate 100% of mixed service costs to production costs allocated to work-in-process and finished goods. Treas. Reg. § 1.263A-2(c)(3)(iii)(C).
3. If mixed service costs are required to be allocated in part to pre-production costs, in addition to the labor cost-based formula in the proposed regulations, a taxpayer using the simplified method for allocating mixed service costs is permitted to allocate mixed service costs to pre-production costs based on the ratio of direct material costs incurred to § 471 costs incurred for the taxable year.

Computation of Allocation Ratio: Cont'd

Taxpayers Using HAR

1. The new regulations require a taxpayer using HAR and wishing to switch to the new MSPM to recompute its HAR percentage over the entire period that HAR was used.
2. In that circumstance, a taxpayer would be advised to terminate HAR and readopt it after three years.
3. Question- Why did the IRS adopt such a restrictive approach, instead of using a cut-off approach or a limited look-back?

Transition Rules

Effective Dates

1. The new regulations become mandatory in taxable years beginning after November 20, 2018 (2019, for calendar-year taxpayers).
2. The regulations also offer the option of early adoption for taxable years beginning before November 20, 2018 and ending after that date (2018, for calendar-year taxpayers).

Transition Rules: Cont'd

Transition Rules

1. Rev. Proc. 2018-56 was issued to accompany the new regulations and provide procedures for making accounting method changes in order to comply with the new regulations.
2. Rev. Proc. 2018-56 waives the five-year rule for eligibility to use the automatic accounting method change to comply with the new regulations.
3. However, Re. Prov. 2018-56 does not waive the under-audit restrictions in Rev. Proc. 2015-13.

4. Question- Why didn't the IRS waive the window period restrictions for audit protection?
5. Accordingly, because of the new rules for classification of costs between § 471 costs and additional § 263A costs, taxpayers under examination would be advised to wait to file an accounting method change request under Rev. Proc. 2018-56 until they reach one of the filing windows in Rev. Proc. 2015-13, in order to obtain audit protection when making the accounting method change.