June 22, 2022

Mr. Scott Vance
Associate Chief Counsel
Income Tax & Accounting
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Section 263A Regulations

Dear Mr. Vance:

The American Institute of CPAs (AICPA) commends the efforts of the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) in issuing guidance related to negative section 263A costs[1]. On November 20, 2018, the IRS and Treasury released final regulations under section 263A ("the 2018 final regulations") that address the allocation of direct and certain indirect costs to property produced or acquired for resale by a taxpayer.

These comments are in response to the 2018 final regulations, and we provide additional examples and recommendations. Specifically, we recommend that Treasury and the IRS provide guidance on the following issues related to the 2018 final regulations:

1. **Allow positive uncapitalized costs to be treated as additional section 263A costs**

   - The general requirement to treat uncapitalized costs as section 471 costs should only apply to negative costs, and Treasury and the IRS should permit taxpayers to treat positive uncapitalized costs as additional section 263A costs.

2. **Update the de minimis rules for uncapitalized costs**

   - Treasury and the IRS should include uncapitalized direct materials, uncapitalized direct costs, and direct labor and standard cost variances as additional section 263A costs in all circumstances. If Treasury and the IRS decline this recommendation to eliminate any and all restrictions on uncapitalized costs that are positive in amount, the AICPA has three alternative proposals:

     i. The percentage thresholds for the de minimis rules for uncapitalized costs should be raised from 5 percent to 10 percent.

     ii. Allow positive and negative amounts to be netted when testing the 5 percent thresholds under the de minimis rules for uncapitalized costs.

[1] All references to "section" or "§" are to the Internal Revenue Code of 1986, as amended, and all references to "Reg. §" and "regulations" are to U.S. Treasury regulations promulgated thereunder, unless otherwise specified.

iii. The special rule for basic compensation and overtime should be eliminated.

3. Expand the ability to use the alternative method of determining section 471 costs

- Treasury and the IRS should adopt the following actions:

  i. Add Reg. § 1.263A-1(d)(6)(iv) to expand availability of the alternative method to include any financial statement that is used for credit purposes; reporting to shareholders, partners, or similar persons; or any other substantial non-tax purpose.

  ii. If the government is unable to expand the use of the alternative method to taxpayers with financial statements under Reg. § 1.263A-1(d)(6)(iv), guidance is needed to assist taxpayers with applying the general method by allowing taxpayers to use a reasonable allocation method for computing section 471 costs in their section 263A calculation. This change to use a reasonable allocation method should be viewed as an automatic method change under Rev. Proc. 2022-14, *List of Automatic Changes, Accounting Methods,* in changing to a method consistent with Reg. § 1.263A-1(d)(2)(i).

4. Allow taxpayers to exclude the residual additional section 263A costs related to non-produced finished goods from the numerator of the modified simplified production method production ratio

- Treasury and the IRS should revise the uniform capitalization ("UNICAP") rules to provide that taxpayers with non-produced finished goods are permitted (but not required) to identify and allocate pre-production additional section 263A costs between direct materials and non-produced finished goods and include only the residual pre-production costs related to direct materials in the numerator of the modified simplified production method (MSPM) production ratio.

- We further recommend an elective simplified allocation methodology whereby pre-production additional section 263A costs would be allocated between direct materials and non-produced finished goods based on the section 471 costs incurred during the year for each respective category of inventory.

5. Clarify the U.S. Ratio Method

- In order to retain the simplicity provided by the U.S. Ratio Method, the U.S. ratio for a foreign business should be defined by Treasury and the IRS as the total additional section 263A costs capitalized to section 471 costs remaining on hand at year end for the applicable U.S. trade or business divided by the total section 471 costs remaining on hand at year end for the applicable U.S. trade or business.

- Treasury and the IRS should update Notice 88-104 to clarify that the U.S. ratio for a foreign business is the historic absorption ratio (HAR) of the applicable U.S. trade or business when the applicable U.S. trade or business uses a simplified method with the HAR. For purposes of the U.S Ratio Method, if the applicable U.S. trade or business uses the MSPM with the HAR, a foreign business should have the option to use (1) a pre-production HAR and a production HAR equal to the pre-production HAR and the production HAR of the applicable U.S. trade or business, or (2) the MSPM combined HAR equal to the weighted average MSPM combined ratio during the test period or updated test period of the applicable U.S. trade or business.

- Treasury and the IRS should clarify that a foreign business using the U.S. Ratio Method is not required to file a change in method of accounting when the applicable U.S. trade or business changes its method of accounting under section 263A. That is, the change would be treated as a change in facts for the foreign business, and the foreign business would simply compute the U.S. ratio for the year of change based on the definition of the U.S. ratio proposed above, taking into account the method change of the applicable U.S. trade or business. This clarification could be made by updating section 12.12 of Rev. Proc. 2022-14 to indicate that a change in the method of accounting for the applicable U.S. trade or business is treated as a change in facts for a foreign business that uses the U.S. Ratio Method.

6. Allow the filing of one combined Form 3115 for section 263A method changes

- Treasury and the IRS should issue guidance providing an exception to the requirement in section 6.04(1) of Rev. Proc 2015-13, *Changes in Accounting Periods and in Methods of Accounting*, so that multiple applicants with different section 263A methods and sub-methods for a particular type of property (e.g., inventory, self-constructed assets) may file a single Form 3115, *Application for Change in Accounting Method*, with a single section 481(a) adjustment and adjustment period for each applicant.

7. Provide an exception from the requirement to capitalize direct labor costs as section 471 costs for resellers that use the simplified resale method and that have de minimis production activities

- Treasury and the IRS should issue guidance providing an exception from the requirement to capitalize direct labor costs as section 471 costs for resellers that use the simplified resale method (SRM) and that have de minimis production activities. This guidance should allow these resellers to treat uncapitalized direct labor costs as additional section 263A handling costs under the SRM.

8. Provide additional rules related to intercompany sales of inventory and deferred additional section 263A costs

- Treasury and the IRS should provide that, for intercompany sales of inventory, the amount of UNICAP costs deferred by the seller is determined by applying the seller's MSPM pre-production ratio to the seller's basis in contract manufactured goods and resale goods sold to the buyer that remain in the buyer's ending inventory and by applying the seller's MSPM production ratio to the seller's basis in produced goods sold to the buyer that remain in the buyer's ending inventory (as if the goods had not been sold and remained in the seller's ending inventory).

- Treasury and the IRS should provide a similar rule for taxpayers with separate trades or businesses when one trade or business sells to another trade or business.

9. Provide for a re-election of the historic absorption ratio

- Treasury and the IRS should provide a transition rule that permits taxpayers to adopt the 2018 final regulations and use a HAR method (i.e., MSPM with HAR, simplified production method (SPM) with HAR, or SRM with HAR) and compute a new HAR using the three most recent taxable years.

- Alternatively, the government should provide a transition rule that permits taxpayers to elect HAR after applying a consistent simplified method for three consecutive years, regardless of whether the taxpayer revoked its previous HAR election within the prior six taxable years, in order to provide equitable rules for similarly situated taxpayers.

10. Allow automatic method changes when financial statement calculations change

- Treasury and the IRS should modify section 12.17 of Rev. Proc. 2022-14 as follows:

  i. Establish a permanent waiver of the five-year eligibility rule for any changes to recharacterize costs resulting from a change to the costs capitalized to inventory in a taxpayer's financial statements.

  ii. Provide taxpayers with the option to implement changes to recharacterize costs on a cut-off basis or with a section 481(a) adjustment if the taxpayer has adequate detail to accurately compute an adjustment.

  iii. Regarding changes made for financial statement costing of inventory that would not be covered by section 12.17 of Rev. Proc. 2022-14, consider adding an automatic method change to allow taxpayers to conform to the methods used for financial reporting purposes.

11. Waive the 5-year eligibility rule for required changes between the alternative method and default method

- Treasury and the IRS should provide relief for a taxpayer that reasonably anticipates its period without an applicable financial statement (AFS) to not

exceed two tax years. In this circumstance, a taxpayer that previously maintained an AFS would be permitted to remain on the alternative method for up to two subsequent tax years without an AFS, and the alternative method would be applied using the taxpayer's books and records in lieu of an AFS.

- The AICPA further recommends that the five-year eligibility rule be waived to permit changes between the alternative method and the default method under sections 12.01 and 12.02 of Rev. Proc. 2022-14 for a three-tax year period beginning with the first year that a taxpayer no longer has an AFS.

12. Clarify how the de minimis rules for uncapitalized costs apply to taxpayers that elect the historic absorption ratio

- Treasury and the IRS should clarify that, if a taxpayer uses the HAR and uses the safe harbor method for uncapitalized variances and under or over-applied burdens during its test period or updated test period, the taxpayer determines whether uncapitalized variances and under or over-applied burdens are included in its section 471 costs remaining on hand at year end during its qualifying period or extended qualifying period according to how those uncapitalized variances and under or over-applied burdens are identified in at least two of the three years of the taxpayer's applicable test period or updated test period.

BACKGROUND

Section 263A requires taxpayers to capitalize direct and indirect costs properly allocable to real or tangible personal property produced by the taxpayer, as well as real property and personal property described in section 1221(a)(1) acquired by the taxpayer for resale. The section 263A regulations prescribe a variety of methods that taxpayers can use to identify and allocate additional section 263A costs, including certain simplified methods for producers and resellers. The 2018 final regulations affect taxpayers that are producers or resellers of property that are required to capitalize costs to the property and that elect to allocate costs using a simplified method. These regulations are effective for taxable years beginning on or after November 20, 2018.

SPECIFIC COMMENTS

1. Allow positive uncapitalized costs to be treated as additional section 263A costs

Overview

Under a section 471 method, which uses a facts-and-circumstances method to allocate costs to inventory, the amount of a cost that is capitalized to ending inventory is almost always less than the amount of the cost that would be capitalized under the SPM or the MSPM.

When direct material costs, direct labor costs, or standard cost variances or under- or over-applied burdens are not capitalized to inventory for financial reporting purposes and these "uncapitalized costs" are treated as additional section 263A costs, rather than as section 471 costs, a greater proportion of the annual amount of the costs are capitalized under the SPM or MSPM.

Thus, when uncapitalized costs are positive in amount, Treasury and the IRS should not be concerned if a taxpayer treats the uncapitalized costs as additional section 263A costs. Requiring the taxpayer to treat these costs as section 471 costs creates a substantial administrative burden for taxpayers. Many taxpayers compute the standard cost of inventory based on complex allocations established by cost accountants and performed by their Enterprise Resource Planning (ERP) system, and it would be extremely costly to re-compute these allocations solely for tax purposes.

Recommendation

The general requirement to treat uncapitalized costs as section 471 costs should only apply to negative costs, and taxpayers should be permitted to treat positive uncapitalized costs as additional section 263A costs.

Analysis

The following example illustrates the concepts discussed above:

Facts – Example 1

1. Assume that T is engaged in the production and sale of widgets. Further assume that T's aggregate inventory turnover cycle is monthly, i.e., inventory turns over 12 times per year.

2. At the beginning of the inventory turnover cycle, T purchases raw materials for use in the production of the widgets.

3. After T acquires the raw materials, the raw materials typically remain in T's storage warehouses for a period of 10 days before the raw materials are withdrawn and enter the production process.

4. Once the raw materials enter the production process, assume that it takes 5 days to produce finished widgets.

5. After production is completed, finished widgets are shipped to storage warehouses where they typically remain in storage for another 15 days. Accordingly, the total inventory turnover cycle from the date of purchase to the date of sale is 30 days, or one month.

6. At the end of the storage period, T processes a customer's order and transports the finished widgets to the customer's location.

7. T uses the full absorption method to capitalize costs to inventory in its financial statements, and T treats the types and amounts of these costs as section 471 costs under the alternative method provided in Reg. § 1.263A-1(d)(2)(iii).

8. T's additional section 263A costs equal $585X in the aggregate for the taxable year, consisting of $120X for finished goods storage, $150X of federal excise taxes on finished widgets, and $315X of Schedule M adjustments for depreciation and employee benefits.

9. Based on the foregoing facts and T's monthly aggregate inventory turnover rate, assume that T's aggregate annual amount of section 471 costs are $12,000X and that the amount of section 471 costs in T's ending FIFO inventory is $1,000X (which equals the cost of one turnover of inventory).

<u>Computation under the SPM</u>

1. Under the SPM, T calculates a single absorption ratio as follows:

   $585X / $12,000X = 4.875%

2. Under the SPM, T multiplies the absorption ratio by its section 471 costs in ending inventory:

   4.875% x $1,000X = $48.75X

3. Accordingly, $48.75X of the $585X annual amount of additional section 263A costs incurred by T is capitalized to T's section 471 ending inventory to arrive at the total section 263A ending inventory.

<u>Analysis of SPM</u>

1. To better understand the mathematics embodied in the SPM, it is helpful to restructure the original formula for the absorption ratio under the SPM to an equivalent formula that produces the identical answer, but arrives at the answer by using the rate of turnover in the taxpayer's inventory:

   Thus, the original formula:

$$\frac{\text{Additional § 263A costs}}{\text{§ 471 costs incurred}} \times \text{§ 471 ending inventory} = \text{Capitalized additional § 263A costs}$$

is transformed into an equivalent formula:

$$\frac{\S\ 471 \text{ ending inventory}}{\S\ 471 \text{ costs incurred}} \times \text{Additional } \S\ 263\text{A costs} = \text{Capitalized additional } \S\ 263\text{A costs}$$

2. This equivalent formula (§ 471 ending inventory divided by § 471 costs incurred) is more recognizable as the formula for computing a taxpayer's rate of inventory turnover.

3. In this example, T's inventory turns over 12 times per year, which equals the average period of one month that it takes for T to purchase raw materials, process the raw materials into finished widgets, and deliver the finished widgets to customers.

4. Thus, under the SPM using the turnover formula approach, one twelfth of T's annual amount of additional section 263A costs would be capitalized to T's ending inventory, the same result as under the formula for the absorption ratio contained in the regulations.

Problems with SPM

1. The foregoing calculations under the SPM are mathematically logical except for one aspect of the calculation -- the average inventory turnover period experienced by a taxpayer does not properly measure the fraction of the annual amount of particular additional section 263A costs that would remain in a taxpayer's ending inventory.

2. The reason that the formula in the SPM produces a distorted answer is that most additional section 263A costs do not turn over at the same rate as section 471 costs.

3. In fact, many additional section 263A costs turn over at a much faster rate than section 471 costs, which means that a much smaller percentage of those additional section 263A costs should be capitalized to ending inventory than in the case of section 471 costs.

4. Moreover, additional section 263A costs almost always turn over at a faster rate than section 471 costs and, as a result, the SPM overstates the amount of positive additional section 263A costs that must be capitalized and the amount of negative additional section 263A costs that should be removed from the taxpayer's section 471 ending inventory.

5. This conclusion may be demonstrated by comparing the results under the SPM with a facts-and-circumstances method, which is the method used by taxpayers to compute their section 471 costs in ending inventory.

Computation under Facts-and-Circumstances (F&C) or a Section 471 Method

1. A section 471 method is normally equivalent to an F&C method under the section 263A regulations.

2. In the foregoing example, examine the length of time that each type of additional section 263A cost remains in ending inventory, rather than focusing on the total length of an average inventory turnover period, which is the formula under SPM.

3. The first additional section 263A cost in the example is the cost of finished goods storage.

    a. While on average it takes one month from the initial purchase of raw materials to the date the finished widgets leave T's inventory, finished widgets are in storage for only 15 days, or one-half of a month.

    b. Accordingly, at most, one-half month of storage costs, instead of the one month of storage costs under SPM, would remain in ending inventory.

    c. However, even the assignment of 15 days of storage costs to ending inventory overstates the portion of the annual amount of storage costs that should be capitalized.

    d. If T's finished widgets are stored on average for 15 days after production is complete, then at any given time the amount of storage costs in inventory for a finished widget is half the total storage time or 7 ½ days. In other words, as finished widgets enter and leave storage, the widgets in ending inventory have been in storage on average for half the amount of the average storage period.

    e. Accordingly, instead of capitalizing one-twelfth of the annual amount of finished goods storage costs as under SPM, only 1/48 (1/12 x ½ x ½) of the annual amount of finished goods storage costs actually remains in T's ending inventory at any given time under a facts and circumstances allocation method.

4. The second additional section 263A cost incurred by T is the federal excise tax on finished widgets.

    a. The federal excise tax on finished widgets is imposed when the finished widgets leave a bonded warehouse.

    b. Typically, finished widgets are not removed from a bonded warehouse until a few days before the products are transported for sale to customers. Accordingly, assume that there are only three days of excise taxes on widgets in T's ending inventory, compared with the formula under SPM, which in the example, allocates 30 days of excise taxes to ending inventory.

5. The third additional section 263A cost incurred by T include the Schedule M adjustments with respect to the capitalizable portion of depreciation and employee benefit costs.

    a. Assume these additional section 263A costs are incurred at the same rate that the section 471 cost of depreciation and employee benefit costs are incurred.

    b. Since these costs relate almost exclusively to production and remain in inventory through the storage of finished widgets, allocating these additional section 263A costs to ending inventory at the same rate as section 471 costs is reasonable, except that under the SPM, the portion of the turnover period when raw materials remain in their raw state should not be included in the absorption ratio for Schedule M adjustments related to production costs.

c. Accordingly, while the SPM allocates 1/12 of the annual amount of additional capitalizable Schedule M adjustments to ending inventory, an F&C method would exclude the raw material stage (10 days) from the absorption ratio.

6. In fairness, the MSPM cures the deficiency in the SPM as it relates to an additional section 263A cost such as capitalizable Schedule M adjustments, by eliminating the turnover period associated with unprocessed raw materials from the absorption ratio. However, the MSPM would capitalize the same amount of finished goods storage and excise taxes as the SPM.

7. Thus, under the F&C method (a section 471 method), the amount of additional section 263A costs that would be capitalized to ending inventory would be as follows:

   a. Finished goods storage

      $120X x 1/12 x ½ x ½ = $2.5X

   b. Excise tax on finished widgets withdrawn from bonded warehouses

      $150X x 1/12 x 3/30 = $1.25X

   c. Schedule M adjustments for capitalizable depreciation and employee benefits

      $315X x 1/12 x 20/30 = $17.5X

   d. Thus, the total additional section 263A costs that would be capitalized under an F&C or section 471 method would be $21.25X, in comparison to $48.75X under the SPM.

<u>Overall considerations</u>

1. An F&C method or a section 471 method will almost always capitalize less costs than the SPM or MSPM.

2. If a taxpayer is willing to use the SPM or the MSPM, the regulations should not force the taxpayer to use a more complex F&C method or a section 471 method to capitalize costs that are not capitalized to inventory in the taxpayer's financial statement, as long as the amount of the uncapitalized costs is positive, because forcing the taxpayer to use an F&C method or section 471 method in that circumstance operates to the disadvantage of the government.

3. Thus, all taxpayers, except for taxpayers with negative uncapitalized costs, should be permitted to treat all adjustments to section 471 inventory, including positive uncapitalized costs, as additional section 263A costs.

4. In other words, it is not necessary for the regulations to have elaborate rules for the calculation of the taxpayer's section 471 inventory or to require taxpayers to treat positive

uncapitalized costs as section 471 costs. That additional work only causes a reduction in the costs capitalized to the taxpayer's ending inventory in comparison to either the SPM or MSPM.

2. Update the de minimis rules for uncapitalized costs

Overview

In conjunction with Example 1 provided above, the de minimis rules for uncapitalized direct material and direct labor costs provided in Reg. § 1.263A-1(d)(2)(iv) and the safe harbor rule for uncapitalized standard cost variances and under- or over-applied burdens provided in Reg. § 1.263A-1(d)(2)(v) (hereinafter collectively referred to as "the de minimis rules for uncapitalized costs") create additional problems. The de minimis rules for uncapitalized costs are designed to permit taxpayers to treat certain direct material costs, direct labor costs, and standard cost variances and under- or over-applied burdens as additional section 263A costs when those amounts are less than five percent of applicable costs.

Example 1 demonstrates that when additional section 263A costs are positive in amount, the proportion of those costs that are capitalized to ending inventory is greater under the SPM or MSPM than under a facts-and-circumstances section 471 method. Accordingly, restrictions on the classification of uncapitalized costs as additional section 263A costs are counterproductive. Example 1 demonstrates that requiring taxpayers to treat uncapitalized costs as section 471 costs, rather than as additional section 263A costs, results in a lesser percentage of those costs being capitalized to ending inventory than if the costs were accounted for as additional section 263A costs under either the SPM or MSPM.

Recommendation

As discussed in the first section above, the AICPA recommends that uncapitalized direct materials, uncapitalized direct costs, and direct labor and standard cost variances should be includible as additional section 263A costs in all circumstances. If Treasury and the IRS decline the AICPA's recommendation to eliminate any and all restrictions on uncapitalized costs that are positive in amount, the AICPA has three alternative proposals:

1. The percentage thresholds for the de minimis rules for uncapitalized costs should be raised from 5 percent to 10 percent.

2. Allow positive and negative amounts to be netted when testing the 5 percent thresholds under the de minimis rules for uncapitalized costs.

3. The special rule for basic compensation and overtime should be eliminated.

Analysis

If Treasury and the IRS retain the requirement to treat certain uncapitalized costs in excess of the de minimis rules as section 471 costs, the AICPA first proposes that the percentage thresholds for the de minimis rules for uncapitalized costs should be raised from 5 percent to 10 percent. There have been many situations when, because of an aberration in operations for a particular taxable

year, the current five percent threshold for uncapitalized costs was exceeded. Requiring a taxpayer to change the classification of particular capitalizable costs from section 263A costs to section 471 costs when the taxpayer does not capitalize those costs to inventory in its financial statement is burdensome and time-consuming and creates significant potential distortions when computing the revaluation factor for dollar-value Last In, First Out (LIFO) inventory under the three-year average method in Reg. § 1.263A-7(c)(2)(v), when computing increments and decrements for dollar-value LIFO inventory, and when computing the HAR under a simplified section 263A method. Accordingly, special rules for uncapitalized costs should be limited to situations when the amount of uncapitalized costs is significant or when the taxpayer's practices result in a significant distortion.

Moreover, if a taxpayer excludes particular costs that are positive in amount from capitalizable costs in its financial statement but is required to treat those costs as section 471 costs, rather than as additional section 263A costs, Example 1 demonstrates that this treatment results in a lesser amount of those costs being capitalized to ending inventory. If the particular costs are negative in amount, the overall effect of treating the uncapitalized costs as negative additional section 263A costs is likely to be negligible in comparison to the aggregate amount of the taxpayer's inventories. Also, due to the requirement to treat negative amounts as positive amounts for purposes of the 5 percent tests, uncapitalized costs, especially standard cost variances, are more likely to exceed the 5 percent threshold. In addition, the section 263A regulations contain numerous other de minimis rules with a 10 percent threshold, including the 90/10 de minimis rule for mixed service departments in Reg. § 1.263A-1(g)(4)(ii), the 90/10 de minimis rule for capitalizable mixed service costs in Reg. § 1.263A-2(c)(3)(iii)(C), the gross receipts test and labor test for determining whether a reseller's production activities are de minimis under Reg. § 1.263A-3(a)(5), and the 90/10 rule for dual function storage facilities in Reg. § 1.263A-3(c)(5)(iii)(C). Accordingly, increasing the 5 percent threshold to 10 percent would be consistent with all other de minimis rules in the section 263A regulations and would help alleviate the significant potential distortions mentioned above as taxpayers implement the UNICAP regulations.

Secondly, because treating positive amounts of uncapitalized costs as additional section 263A costs, rather than as section 471 costs, does not reduce a taxpayer's taxable income, the 5 percent (or 10 percent, if modified) tests should allow the netting of positive and negative amounts. If only negative additional section 263A costs have the potential to distort the measurement of a taxpayer's inventory for tax purposes, the true potential distortive effects of treating uncapitalized costs as additional section 263A costs is best captured by netting the positive and negative amounts of such costs. The inability to net positive and negative adjustments is particularly problematic with standard cost variances because it is not clear at what level these variances should be distinguished from one another. Most businesses only track variances in aggregate or by variance type (e.g., price variance, usage variance, etc.) meaning that this rule is applied inconsistently by similarly situated businesses.

Thirdly, Reg. § 1.263A-1(d)(2)(iv)(B) provides that basic compensation and overtime direct labor costs must always be treated as section 471 costs, and these costs are not eligible for the de minimis rule for uncapitalized labor costs. The UNICAP regulations contain very specific definitions of what constitutes basic compensation and overtime in computing direct labor costs. As such, because of differences in the definition of direct labor costs between the UNICAP regulations and financial reporting rules, it is quite possible there may be elements of basic compensation or overtime direct labor costs that are not capitalized to inventory in a taxpayer's financial statements.

However, unlike all other uncapitalized costs, the UNICAP regulations provide that these uncapitalized costs must be treated as section 471 costs, even if these costs are de minimis. No abuse or distortion occurs when de minimis basic compensation and overtime direct labor costs are treated as additional section 263A costs. Accordingly, the special rule for basic compensation and overtime direct labor costs should be eliminated. Further, determining the amount of basic compensation and overtime direct labor is not always possible, particularly for small and medium taxpayers with less sophisticated accounting systems. These systems may capture and report wages and overtime in a single general ledger account without breaking the costs down precisely into direct labor and indirect labor. Thus, these businesses cannot comply with this requirement.

As noted above, these proposals are closely related to the proposals under Issue 1 above and should be considered together. Example 1 provided above is equally illustrative of the points made herein.

3. Expand the ability to use the alternative method of determining section 471 costs

<u>Overview</u>

Reg. § 1.263A-(d)(4) defines section 263A costs to include all costs that a taxpayer must capitalize under section 263A, which is the sum of a taxpayer's section 471 costs, its additional section 263A costs, and any interest capitalizable under section 263A(f). Generally, methods of accounting under section 263A require quantifying both a taxpayer's section 471 costs and its additional section 263A costs incurred. Reg. § 1.263A-1(d)(2) provides two methods a taxpayer may utilize to determine section 471 costs for purposes of section 263A calculations, a general method and an alternative method.

Under the general method, as defined under Reg. § 1.263A-1(d)(2)(i), section 471 costs are the <u>types</u> of costs, other than interest, that a taxpayer capitalizes to property produced or acquired for resale in its financial statement. Notably, under the general method, a taxpayer uses the amounts of such costs as incurred for federal income tax purposes, rather than the amounts used for financial statement purposes. In addition, section 471 costs must include all direct labor and direct material costs incurred, which is discussed in greater detail above. This calculation of section 471 costs is difficult and burdensome because it requires a taxpayer to maintain two separate inventory valuation systems, one for financial reporting and another for tax reporting purposes.

Under the alternative method, as defined under Reg. § 1.263A-1(d)(2)(iii), a taxpayer determines section 471 costs by using the <u>types</u> and <u>amounts</u> of costs that are incurred in a taxable year in its financial statement under the taxpayer's financial statement method of accounting. A taxpayer using the alternative method must include, as additional section 263A costs, all negative and positive adjustments required to be made because of differences in the book and tax amounts of the taxpayer's section 471 costs, including adjustments for direct costs required to be added to section 471 costs under Reg. § 1.263A-1(d)(2)(ii) and costs removed from section 471 costs under Reg. § 1.263A-1(d)(2)(vi).

Use of the alternative method is available only if a taxpayer's financial statement is described under Reg. § 1.263A-1(d)(6)(i)-(iii):

- A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or Annual Statement to Shareholders).

- A certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for credit purposes; reporting to shareholders, partners, or similar persons; or any other substantial non-tax purpose.

- A financial statement (other than a tax return) required to be provided to the federal or state government or any federal or state agency (other than the SEC or the IRS).

Recommendation:

The AICPA recommends that Treasury and the IRS adopt the following actions:

- Add Reg. § 1.263A-1(d)(6)(iv) to expand availability of the alternative method to include any financial statement that is used for credit purposes; reporting to shareholders, partners, or similar persons; or any other substantial non-tax purpose.

- If the government is unable to expand the use of the alternative method to taxpayers with financial statements under Reg. § 1.263A-1(d)(6)(iv), guidance is needed to assist taxpayers with applying the general method by allowing taxpayers to use a reasonable allocation method for computing section 471 costs in their section 263A calculation. This change to use a reasonable allocation method should be viewed as an automatic method change under Rev. Proc. 2022-14 in changing to a method consistent with Reg. § 1.263A-1(d)(2)(i).

Analysis:

Under the general method of determining section 471 costs, a taxpayer is required to complete a separate calculation of the costs required to be capitalized as section 471 costs before it computes the additional costs under section 263A. In many cases, this would require the taxpayer to maintain two separate inventory costing systems.

In practice, determining section 471 costs using the alternative method is generally consistent with how taxpayers have historically computed adjustments under section 263A. A taxpayer's books and records are the starting point, in general, for its computation of taxable income for federal income tax purposes and determining the additional costs required to be capitalized under section 263A. This approach is very common for taxpayers that prepare financial statements under generally accepted accounting principles that don't qualify to use the alternative method under Reg. § 1.263A-1(d)(2)(iii).

Many differences may arise between a taxpayer's capitalizable costs for financial statement purposes and its section 471 costs as determined under the general method describe above. The main area impacted by these rules are differences between book and tax amounts related to capitalizable costs incurred for financial statement and federal income tax purposes (e.g., machinery and equipment depreciation or production labor). Under the alternative method, these differences are accounted for as additional section 263A costs.

Applying the general section 471 method requires a taxpayer to complete a multi-step process in order compute the costs to be capitalized under section 263A. First, a taxpayer must identify the types of costs capitalized to inventory for financial reporting purposes that have a different amount incurred for tax reporting purposes. Once identified, taxpayers are required redetermine the tax amount to be capitalized as a section 471 cost by adjusting both the section 471 costs incurred during the year and the section 471 costs on hand at year end. The taxpayer then determines the additional section 263A costs to be capitalized to ending inventory. This process can be very cumbersome if a taxpayer is required to complete this computation using unit level costing consistent with the method used for financial reporting purposes.

A taxpayer's capitalization of costs for financial statement purposes is often provided through automated ERP or separate inventory cost management systems and/or other complex calculations prepared by cost accountants. As a result, an accurate computation of section 471 costs associated with inventory on hand at year-end, considering allocable book-tax differences for those costs, is impractical or impossible for many taxpayers, both from a process and timing standpoint.

Many small to medium sized taxpayers are subject to section 263A and have complicated inventory systems, but they do not issue financial statements meeting the current alternative method criteria described above. As such, they are burdened with determining how to compute section 471 costs on hand at year end using tax adjusted costs under the general section 471 method. This is one of the few areas of tax law where small and medium-sized taxpayers are required to follow are more complex set of rules than larger taxpayers. Broadening the availability of the alternative method for determining section 471 costs would alleviate many of the issues outlined above.

If a taxpayer doesn't qualify to utilize the alternative section 471 method and is required to compute a separate section 471 inventory amount specifically for completion of the section 263A calculation, the government should allow taxpayers to use a reasonable method to capitalize those costs.

4. **Allow taxpayers to exclude the residual additional section 263A costs related to non-produced finished goods from the numerator of the MSPM production ratio**

Overview

Under the current MSPM rules, a taxpayer that owns resale finished goods or finished goods produced under contract ("non-produced finished goods") and production inventory must include residual pre-production additional section 263A costs attributable to both non-produced finished goods and direct materials in the numerator of the production ratio. If the taxpayer's pre-production additional section 263A costs predominantly relate to non-produced finished goods, then the MPSM production ratio and the amount of additional section 263A costs capitalized to production ending inventory are significantly distorted.

Recommendations

The AICPA recommends that the UNICAP rules be revised to provide that taxpayers with non-produced finished goods are permitted (but not required) to identify and allocate pre-production additional section 263A costs between direct materials and non-produced finished goods and

include only the residual pre-production costs related to direct materials in the numerator of the MSPM production ratio.

We further recommend an elective simplified allocation methodology whereby pre-production additional section 263A costs would be allocated between direct materials and non-produced finished goods based on the section 471 costs incurred during the year for each respective category of inventory.

Analysis

The examples below demonstrate the distortion caused by including residual pre-production additional section 263A costs related to non-produced finished goods in the numerator of the MSPM production ratio.

Example 2 – All residual pre-production additional section 263A costs are included in the numerator of the MSPM production ratio

Company A uses the first-in, first-out (FIFO) inventory method. Company A had the following direct material costs in beginning inventory and incurred the following costs during the year:

Direct material costs in beginning inventory	A	$17,000,000
Incurred During the Year		
Direct material costs	B	$41,440,000
Resale finished goods	C	$994,560,000
Pre-production section 471 costs	D=B+C	$1,036,000,000
Production section 471 costs	E	$64,665,000
Pre-production additional section 263A costs	F	$103,600,000
Production additional section 263A costs	G	$28,400,000
Total	H=D+E+F+G	$1,232,665,000

Company A's section 471 costs in ending inventory consisted of the following:

Ending Inventory		
Direct material costs	I	$16,440,000
Resale finished goods	J	$183,560,000
Pre-production section 471 costs	K=I+J	$200,000,000
Production section 471 costs	L	$25,000,000
Total section 471 costs	M=K+L	$225,000,000

Company A computes the following capitalized additional section 263A costs under the MSPM:

Pre-Production Additional Section 263A Costs Capitalized to Ending Inventory		
Pre-production additional section 263A costs	F	$103,600,000
Pre-production section 471 costs incurred during the year	D	$1,036,000,000
MSPM pre-production ratio	N=D/F	10.00%
Pre-production section 471 costs in ending inventory	K	$200,000,000
Pre-production additional section 263A costs capitalized to ending inventory	O=N*K	$20,000,000
Production Additional Section 263A Costs Capitalized to Ending Inventory		
Production additional section 263A costs	G	$28,400,000
Residual pre-production additional section 263A costs	P=F-O	$83,600,000
Numerator of production ratio	Q=G+P	$112,000,000
Production section 471 costs incurred during the year	E	$64,665,000
Direct materials adjustment	R=A+B-I	$42,000,000
Denominator of production ratio	S=E+R	$106,665,000
MSPM production ratio	T=Q/S	105.00%
Production section 471 costs in ending inventory	L	$25,000,000
Production additional section 263A costs capitalized to ending inventory	U=T*L	$26,250,000
Total Additional Section 263A Costs Capitalized to Ending Inventory	V=O+U	$46,250,000

Under the present MSPM rules, Company A has residual pre-production additional section 263A costs of $83,600,000, and Company A includes this entire amount in the numerator of the MSPM production ratio, even though most of the costs relate to resale finished goods. As a result, Company A's MSPM production ratio is 105%, the amount of production additional section 263A costs capitalized to ending inventory is equal to $26,250,000, and the total amount of additional section 263A costs capitalized to ending inventory is $46,250,000.

Example 3 – Only residual pre-production additional section 263A costs related to direct materials are included in the numerator of the MSPM production ratio

Same facts as Example 2 except that, pursuant to proposed guidance recommended by the AICPA, Company A elects to use a reasonable allocation method to allocate residual pre-production additional section 263A costs between direct materials and resale finished goods.

Company A computes the following capitalized additional section 263A costs under the MSPM:

Pre-Production Additional Section 263A Costs Capitalized to Ending Inventory

Direct material costs incurred during the year	B	$41,440,000
MSPM pre-production ratio	N	10.00%
Pre-production additional section 263A costs allocable to direct materials	X=B*N	$4,144,000
Section 471 costs of direct materials in ending inventory	I	$16,440,000
MSPM pre-production ratio	N	10.00%
Pre-production additional section 263A costs capitalized to direct materials in ending inventory	Y=I*N	$1,644,000
Residual pre-production additional section 263A costs	Z=X-Y	$2,500,000
Section 471 costs of resale finished goods in ending inventory	J	$183,560,000
MSPM pre-production ratio	N	10.00%
Pre-production additional section 263A costs capitalized to resale finished goods in ending inventory	AA=J*N	$18.356.000
Total pre-production additional section 263A costs capitalized to ending inventory	AB=Y+AA	$20,000,000
Production Additional Section 263A Costs Capitalized to Ending Inventory		
Production additional section 263A costs	G	$28,400,000
Residual pre-production additional section 263A costs	Z	$2,500,000
Numerator of production ratio	AC=G+Z	$30,900,000
Denominator of production ratio	S	$106,665,000
MSPM production ratio	AD=AC/S	28.97%
Production section 471 costs in ending inventory	L	$25,000,000
Production additional section 263A costs capitalized to ending inventory	AE=AD*L	$7,242,300
Total Additional Section 263A Costs Capitalized to Ending Inventory	AF=AB+AE	$27,242,300

Under the MSPM rules proposed by the AICPA, Company A has residual pre-production additional section 263A costs of $2,500,000, and Company A includes this amount in the numerator of the MSPM production ratio, which is appropriate because this amount is allocable to direct material costs included in production costs. As a result, Company A’s MSPM production ratio is 28.97%, the amount of production additional section 263A costs capitalized to ending inventory is equal to $7,242,300, and the total amount of additional section 263A costs capitalized to ending inventory is $27,242,300.

5. Clarify the U.S. Ratio Method

A. Allow foreign businesses to apply a U.S. ratio equal to the total additional section 263A costs capitalized to ending inventory for the applicable U.S. trade or business divided by the total section 471 costs in ending inventory for the applicable U.S. trade or business

Overview

Notice 88-104 provides that, under the U.S. Ratio Method, the additional costs (other than interest) required to be capitalized by a foreign person under section 263A ("additional section 263A costs") are to be allocated to property produced or property acquired for resale by a foreign person in the same proportion that such costs are required to be allocated to property produced or property acquired for resale in the applicable U.S. trade or business of a related taxpayer (the "applicable U.S. trade or business"). Notice 88-104 further provides that the costs (as determined before the application of the rules of section 263A) of property produced or property acquired for resale by a foreign person shall be increased by the factor, based on the costs incurred by the related taxpayer with respect to the applicable U.S. trade or business, that represents the ratio ("the U.S. ratio") of additional section 263A costs to otherwise capitalizable costs incurred by the related taxpayer in such trade or business for each particular taxable year.

It is currently unclear how a foreign business should apply the U.S. Ratio Method provided in Notice 88-104 when the applicable U.S. trade or business is using the MSPM. Specifically, there is uncertainty regarding whether the foreign business must apply the current formula in Notice 88-104, which is essentially the SPM ratio, or whether the foreign business may apply either (1) the MSPM pre-production ratio of the applicable U.S. trade or business to its pre-production ending inventory and the MSPM production ratio of the applicable U.S. trade or business to its production ending inventory, or (2) a combined ratio (equal to the MSPM combined ratio for LIFO inventory provided in Reg. § 1.263A-2(c)(3)(iv)(B)(2)) of the applicable U.S. trade or business to its total ending inventory.

A U.S. reseller using the simplified resale method (SRM) provided in Reg. § 1.263A-3(d)(3) computes a combined absorption ratio equal to the sum of the storage and handling absorption ratio and the purchasing absorption ratio. Under Reg. § 1.263A-3(d)(3)(i)(D), the storage and handling absorption ratio is equal to storage and handling costs incurred during the year divided by the beginning inventory plus purchases during the year. Under Reg. § 1.263A-3(d)(3)(i)(E), the purchasing absorption ratio is equal to purchasing costs incurred during the year divided by purchases during the year. Based on the language in Notice 88-104, it is unclear whether a foreign business must apply the ratio provided in Notice 88-104 or may use the SRM combined absorption ratio when the applicable U.S. trade or business uses the SRM.

Recommendation

The AICPA recommends that, to retain the simplicity provided by the U.S. Ratio Method, the U.S. ratio for a foreign business should be defined as the total additional section 263A costs capitalized to section 471 costs remaining on hand at year end for the applicable U.S. trade or business divided by the total section 471 costs remaining on hand at year end for the applicable U.S. trade or business.

Analysis

Defining the U.S. ratio as the total additional section 263A costs capitalized to section 471 costs remaining on hand at year end (i.e., ending inventory) for the applicable U.S. trade or business divided by the total section 471 costs in ending inventory for the applicable U.S. trade or business provides a universal ratio that foreign businesses may use, regardless of the section 263A method used by the applicable U.S. trade or business. Under this definition, the U.S. ratio will be equivalent to (1) the SPM ratio when the applicable U.S. trade or business uses the SPM, (2) the SRM combined absorption ratio when the applicable U.S. trade or business uses the SRM, and (3) the MSPM combined absorption ratio when the applicable U.S. trade or business uses the MSPM. Foreign businesses can also use this single definition of the U.S. ratio when the applicable U.S. trade or business uses a burden rate method or other reasonable allocation method to allocate additional section 263A costs to ending inventory.

The examples below demonstrate the computation of the U.S. ratio under the definition proposed above for an applicable U.S. trade or business that uses the SPM, an applicable U.S. trade or business that uses the SRM, and an applicable U.S. trade or business that uses the MSPM.

Example 4 – Applicable U.S. trade or business uses the SPM.

Additional section 263A costs incurred during the year	A	$10,600,000
Section 471 costs incurred during the year	B	$106,000,000
SPM absorption ratio	C=A/B	10.00%
Total section 471 costs in ending inventory	D	$20,000,000
Total additional section 263A costs capitalized to ending inventory	E=C*D	$2,000,000

Total additional section 263A costs capitalized to ending inventory	E	$2,000,000
Total section 471 costs in ending inventory	D	$20,000,000
U.S. ratio	F=E/D	10.00%

Example 5 – Applicable U.S. trade or business uses the SRM.

Purchasing costs incurred during the year	A	$1,500,000
Purchases during the year	B	$100,000,000
Purchasing absorption ratio	C=A/B	1.50%
Storage and handling costs incurred during the year	D	$6,000,000
Beginning inventory + Purchases during the year	E	$120,000,000
Storage and handling absorption ratio	F=D/E	5.00%
SRM combined absorption ratio	G=C+F	6.50%

Total section 471 costs in ending inventory	H	$22,000,000
Total additional section 263A costs capitalized to ending inventory	I=G*H	$1,430,000

Total additional section 263A costs capitalized to ending inventory	I	$1,430,000
Total section 471 costs in ending inventory	H	$22,000,000
U.S. ratio	J=I/H	6.50%

Example 6 – Applicable U.S. trade or business uses the MSPM.

Pre-production additional section 263A costs incurred during the year	A	$1,200,000
Pre-production section 471 costs incurred during the year	B	$80,000,000
MSPM pre-production ratio	C=A/B	1.50%
Pre-production section 471 costs in ending inventory	D	$15,000,000
Pre-production additional section 263A costs capitalized to pre-production section 471 costs in ending inventory	E	$225,000
Production additional section 263A costs incurred during the year + Residual pre-production additional section 263A costs	F	$18,200,000
Production section 471 costs incurred during the year + Direct materials adjustment	G	$130,000,000
MSPM production ratio	H	14.00%
Production section 471 costs in ending inventory	I	$45,000,000
Production additional section 263A costs capitalized to production section 471 costs in ending inventory	J=H*I	$6,300,000

Total additional section 263A costs capitalized to ending inventory	K=E+J	$6,525,000
Total section 471 costs in ending inventory	L=D+I	$60,000,000
U.S. ratio	M=K/L	10.875%

B. *Clarify that a foreign business using the U.S. Ratio Method may apply the HAR of the applicable U.S. trade or business that uses a simplified method with the HAR*

<u>Recommendation</u>

The AICPA recommends that Notice 88-104 be updated to clarify that the U.S. ratio for a foreign business is the HAR of the applicable U.S. trade or business when the applicable U.S. trade or business uses a simplified method with the HAR. For purposes of the U.S Ratio Method, if the applicable U.S. trade or business uses the MSPM with the HAR, a foreign business should have the option to use (1) a pre-production HAR and a production HAR equal to the pre-production HAR and the production HAR of the applicable U.S. trade or business, or (2) the MSPM combined

HAR equal to the weighted average MSPM combined ratio during the test period or updated test period of the applicable U.S. trade or business.

Analysis

Similar to the issues described above, due to the literal language in Notice 88-104, it is unclear whether a foreign business using the U.S. Ratio Method may apply the HAR if the applicable U.S. trade or business uses a simplified method with the HAR. Furthermore, it is unclear how a foreign business applies the U.S. Ratio Method if the applicable U.S. trade or business uses the MSPM with the HAR. In this situation, the foreign business should be permitted to use the pre-production HAR and the production HAR of the applicable U.S. trade or business. In addition, to maintain the simplicity offered by Notice 88-104, the foreign business should have the option to use a U.S. ratio equal to the MSPM combined HAR of the applicable U.S. trade or business in accordance with the following example.

Example 7 – Foreign business uses the U.S. Ratio Method with a U.S. ratio equal to the MSPM combined HAR of the applicable U.S. trade or business.

Foreign Company F uses the U.S. Ratio Method, and the applicable U.S. trade or business uses the MSPM with the HAR. F elects to use a U.S. ratio equal to the MSPM combined HAR of the applicable U.S. trade or business. The MSPM combined HAR of the applicable U.S. trade or business is equal to the weighted average MSPM combined ratio during the test period of the applicable U.S. trade or business, computed as follows:

	A	**B**	**C = A + B**
Test Period	**Pre-Production Add'l Section 263A Costs Capitalized to Ending Inventory**	**Production Add'l Section 263A Costs Capitalized to Ending Inventory**	**Total Add'l Section 263A Costs Capitalized to Ending Inventory**
12/31/2019	$360,000	$1,760,000	$2,120,000
12/31/2020	$350,000	$1,800,000	$2,150,000
12/31/2021	$437,500	$2,450,000	$2,887,500
Totals	$1,147,500	$6,010,000	$7,157,500
			D

	E	**F**	**G = E + F**
Test Period	**Pre-Production Section 471 Costs in Ending Inventory**	**Production Section 471 Costs in Ending Inventory**	**Total Section 471 Costs in Ending Inventory**
12/31/2019	$30,000,000	$16,000,000	$46,000,000
12/31/2020	$28,000,000	$15,000,000	$43,000,000
12/31/2021	$31,250,000	$17,500,000	$48,750,000
Totals	$89,250,000	$48,500,000	$137,750,000

			H

$$\frac{\text{Total Add'l Section 263A Costs Capitalized to Ending Inventory During the Test Period}}{\text{Total Section 471 Costs in Ending Inventory During the Test Period}} = \text{MSPM Combined HAR}$$

$$\frac{\mathbf{D}\quad 7{,}157{,}500}{\mathbf{H}\quad \$137{,}750{,}000} = 5.196\%$$

F uses this MSPM combined HAR of the applicable U.S. trade or business as its U.S. ratio under the U.S. Ratio Method. This method enables F to apply a single ratio to its total section 471 costs in ending inventory and avoid the complexity of separating its ending inventory into pre-production ending inventory and production ending inventory.

C. *Clarify that a foreign business using the U.S. Ratio Method is not required to change its method of accounting when the applicable U.S. trade or business changes its method of accounting under section 263A*

Recommendation

The AICPA recommends that Treasury and the IRS should clarify that a foreign business using the U.S. Ratio Method is not required to file a change in method of accounting when the applicable U.S. trade or business changes its method of accounting under section 263A. That is, the change would be treated as a change in facts for the foreign business, and the foreign business would simply compute the U.S. ratio for the year of change based on the definition of the U.S. ratio proposed above, taking into account the method change of the applicable U.S. trade or business. This clarification could be made by updating section 12.12 of Rev. Proc. 2022-14 to indicate that a change in the method of accounting for the applicable U.S. trade or business is treated as a change in facts for a foreign business that uses the U.S. Ratio Method.

Analysis

While most practitioners believe that a change in method of accounting under section 263A by the applicable U.S. trade or business is a change in facts for the foreign business using the U.S. Ratio Method, Notice 88-104 does not address whether the underlying change in computation of the U.S. ratio should be viewed a change in method of accounting for the foreign business.

6. Allow the filing of one combined Form 3115 for section 263A method changes

Overview

Under section 6.02(1) of Rev. Proc. 2015-13, a taxpayer may request only one method change per Form 3115 and must file separate Forms 3115 if requesting more than one method change for unrelated items or sub-method, unless the IRS has specifically permitted the unrelated changes to be filed on a single form. Section 6.02(4) of Rev. Proc. 2015-13 provides that, except as provided in sections 9.02 and 15.07(4) of Rev. Proc. 2022-1, taxpayers with multiple trades or businesses

must submit a separate Form 3115 for each trade or business for which a method change is requested. Similarly, section 6.02(5) of Rev. Proc. 2015-13 provides that a consolidated group must file a separate Form 3115 for each member of the consolidated group, and for each trade or business of each member, except as provided in sections 9.02 and 15.07(4) of Rev. Proc. 2022-1.

Section 9.02 of Rev. Proc. 2022-1 echoes this general rule and provides that a taxpayer may request only one method change on a Form 3115 and must submit a separate Form 3115 for each unrelated item, except in situations in which the IRS has specifically permitted unrelated changes to be included on a single Form 3115 (and cross-references section 15.07(4) of the same revenue procedure as an example of where the IRS has permitted multiple changes to be filed on a single Form 3115).

Section 15.07(4) of Rev. Proc. 2022-1 provides a reduced user fee for situations where multiple applicants are requesting identical method changes. The implication of the cross-references to section 15.07(4) of Rev. Proc. 2022-1 noted above is that, in order to file a single Form 3115 for multiple applicants, the applicants must be requesting identical method changes. To qualify as an identical method change, section 15.07(4) of Rev. Proc. 2022-1 further provides that the applicants must be requesting to change from an identical present method(s) to identical proposed method(s). In particular, all aspects of the requested method change must be identical, including the present and proposed methods and the authority for the request.

However, section 263A calculations are comprised of a collection of different methods and sub-methods, including methods of determining whether to capitalize a variety of different types of costs, methods of determining the amounts of costs capitalized as section 471 costs, methods of allocating mixed service costs, methods of allocating additional section 263A costs to property, and various special allocation methods and de minimis rules. In addition, different business operations may require that related applicants use different allocation methods (for example, the different allocation methods applicable to producers versus resellers). The large number of different methods and sub-methods used in preparing a section 263A calculation make it very difficult for taxpayers to conclude that two or more related applicants are changing from identical present methods to identical proposed methods. For example, one small difference in the present methods (for example, whether the applicants currently capitalize a particular cost), or a difference in business operations (requiring one taxpayer to use the SRM and another to use the SRM), can result in the need for two or more separate Forms 3115.

<u>Recommendation</u>

The AICPA recommends that Treasury and the IRS issue guidance providing an exception to the requirement in section 6.04(1) of Rev. Proc 2015-13 so that multiple applicants with different section 263A methods and sub-methods for a particular type of property (e.g., inventory, self-constructed assets) may file a single Form 3115, with a single section 481(a) adjustment and adjustment period for each applicant.

<u>Analysis</u>

Filing a single Form 3115 for all related section 263A changes for a particular type of property would be beneficial to taxpayers and would significantly streamline the method change process. Requiring multiple Forms 3115 filings where applicants are using similar, but not identical, present

and proposed methods is burdensome on practitioners and on taxpayers that have multiple section 263A changes to implement.

For example, assume that Taxpayer A has two trades or businesses: Business B and Business C. Both businesses are producers under the section 263A regulations, and both use the SPM. Under the present method, Business B allocates mixed service costs using a fact and circumstances method, while Business C allocates mixed service costs using the simplified service cost method. Under the present method, Business B correctly classifies costs as section 471 costs and section 263A costs; however, Business C currently classifies certain costs as additional section 263A costs that are in fact capitalized for book purposes and, therefore, should be classified as section 471 costs instead. Taxpayer A is proposing to change the section 263A methods of its two businesses as follows (all of which qualify for automatic consent):

A. Both businesses will change to the MSPM.
B. Both businesses will use the simplified service cost method to allocate mixed service costs. However, Business B will use the labor-based allocation ratio, while Business C will use the production cost ratio.
C. Business C will recharacterize certain additional section 263A costs as section 471 costs. Business B is not recharacterizing costs.

Under Rev. Proc. 2015-13 and Rev. Proc. 2022-1, Taxpayer A would need to file two separate Forms 3115: one for Business B and one for Business C. However, Taxpayer A would need to calculate three section 481(a) adjustments:

- Business B section 263A method change
- Business C section 263A method change (excluding change to recharacterize costs)
- Business C section 263A method change to recharacterize costs

Under the AICPA's recommendation, Taxpayer A would file a single Form 3115 and would only need to calculate two section 481(a) adjustments: one for Business B and one for Business C (which would include both the effects of the change to recharacterize costs as well as all other aspects of Business C's section 263A method changes).

7. Provide an exception from the requirement to capitalize direct labor costs as section 471 costs for resellers that use the SRM and that have de minimis production activities

Overview

Under Reg. § 1.263A-3(a)(4)(i), a taxpayer engaged in both production and resale activities with respect to property subject to section 263A may not use the SRM provided in Reg. § 1.263A-3(d)(3) unless the exceptions in Reg. §§ 1.263A-3(a)(4)(ii) or (iii) apply. Reg. § 1.263A-3(a)(4)(ii) provides that a reseller otherwise permitted to use the SRM may use the SRM if its production activities with respect to property subject to section 263A are de minimis (as defined in Reg. § 1.263A-3(a)(2)(iii)) and incident to its resale of eligible property.

Reg. § 1.263A-3(a)(2)(iii) provides that production activities are presumed de minimis if (i) the gross receipts from the sale of the property produced by the reseller are less than 10 percent of the

total gross sales of the trade or business; and (ii) the labor costs allocable to the production activities of the trade or business are less than 10 percent of the reseller's total labor costs allocable to its trade or business.

Reg. § 1.263A-1(d)(2)(iv)(B) provides a de minimis rule for taxpayers with uncapitalized direct labor costs. Under this de minimis rule, a taxpayer with uncapitalized direct labor costs includes in additional section 263A costs, and excludes from section 471 costs, all direct labor costs that are incurred in the taxable year, if those costs are less than five percent of total direct labor costs incurred in the taxable year (whether or not capitalized in the taxpayer's financial statement). The amounts of uncapitalized direct labor costs for this five percent test, and the amounts of uncapitalized labor costs included in additional section 263A costs under this de minimis rule, must not include amounts related to basic compensation or overtime, or the types of costs included in the taxpayer's standard cost or burden rate methods used for section 471 costs. Such costs are required to be treated as section 471 costs and are not permitted to be included in additional 263A costs.

Recommendation

The AICPA recommends that Treasury and the IRS issue guidance providing an exception from the requirement to capitalize direct labor costs as section 471 costs for resellers that use the SRM and that have de minimis production activities. This guidance should allow these resellers to treat uncapitalized direct labor costs as additional section 263A handling costs under the SRM.

Analysis

For financial reporting, many resellers with de minimis production activities do not capitalize direct labor costs to the produced inventory. These resellers would not qualify to treat direct labor costs as additional section 263A costs under the five percent de minimis rule for direct labor costs because 100 percent of the direct labor costs is not capitalized, and the costs would include basic compensation and overtime. However, to be eligible to use the SRM, the resellers have already determined that the production activities are de minimis under Reg. § 1.263A-3(a)(2)(iii). These resellers should not be required to perform a burdensome calculation to adjust section 471 costs for uncapitalized direct labor costs that are de minimis relative to the overall activities of the reseller.

8. Provide additional rules related to intercompany sales of inventory and deferred additional section 263A costs

A. Allow selling member to apply its MSPM pre-production ratio to compute the amount of deferred additional section 263A costs related to intercompany sales of contract manufactured goods and resale goods and its MSPM production ratio to compute the amount of deferred additional section 263A costs related to intercompany sales of produced goods

Overview

Reg. § 1.1502-13(a)(1) provides rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions. Reg. § 1.1502-13(a)(2) provides that, under

this section, the selling member (S) and the buying member (B) are treated as separate entities for some purposes but as divisions of a single corporation for other purposes. The *amount* and *location* of S's intercompany items and B's corresponding items are determined on a separate entity basis (separate entity treatment). For example, S determines its gain or loss from a sale of property to B on a separate entity basis, and B has a cost basis in the property. The *timing,* and the *character, source,* and other *attributes* of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined under this section to produce the effect of transactions between divisions of a single corporation (single entity treatment). For example, if S sells land to B at a gain and B sells the land to a nonmember, S does not take its gain into account until B's sale to the nonmember.

Reg. § 1.1502-13(b)(1) provides that an intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction. S is the member transferring property or services, and B is the member receiving the property or services. Intercompany transactions include S's sale of property (or other transfer, such as an exchange or contribution) to B, whether or not gain or loss is recognized.

Reg. § 1.1502-13(b)(2)(ii) provides that S's costs or expenses related to an intercompany transaction are included in determining its intercompany items. For example, if S sells inventory to B, S's direct and indirect costs properly includible under section 263A are included in determining its intercompany income.

Reg. § 1.1502-13(c)(1) provides a matching rule under which B's corresponding items and S's intercompany items are taken into account. Reg. § 1.1502-13(c)(1)(i) provides that the separate entity attributes of S's intercompany items and B's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income and consolidated tax liability as if S and B were divisions of a single corporation and the intercompany transactions were between divisions.

<u>Recommendations</u>

The AICPA recommends that Treasury and the IRS provide that, for intercompany sales of inventory, the amount of UNICAP costs deferred by the seller is determined by applying the seller's MSPM pre-production ratio to the seller's basis in contract manufactured goods and resale goods sold to the buyer that remain in the buyer's ending inventory and by applying the seller's MSPM production ratio to the seller's basis in produced goods sold to the buyer that remain in the buyer's ending inventory (as if the goods had not been sold and remained in the seller's ending inventory).

The AICPA also recommends Treasury and the IRS provide a similar rule for taxpayers with separate trades or businesses when one trade or business sells to another trade or business.

<u>Analysis</u>

Under the rules provides above, if a member of a consolidated group (S) sells inventory to another member of the consolidated group (B), then S must compute and defer direct and indirect costs properly allocable to the inventory under section 263A until B sells the inventory to a nonmember. If S is a producer using the SPM, S would typically compute the amount of deferred additional

section 263A costs by applying its SPM absorption ratio to its basis in the inventory sold to B that remains in B's ending inventory. Similarly, if S is a reseller using the SRM, S would typically compute the amount of deferred additional section 263A costs by applying its SRM combined absorption ratio to its basis in the inventory sold to B that remains in B's ending inventory.

However, if S is a producer using the MSPM, it is currently unclear how S should compute the amount of deferred additional section 263A costs related to inventory sold to B that remains in B's ending inventory. In this situation, we recommend that S be permitted to apply its MSPM pre-production ratio to its basis in contract manufactured goods and resale goods sold to B that remain in B's ending inventory and its MSPM production ratio to its basis in produced goods sold to B that remain in B's ending inventory.

Example 8

S is a producer using the MSPM with the following absorption ratios:

MSPM pre-production ratio	A	5.0000%
MSPM production ratio	B	18.0000%

S's total section 471 costs remaining in ending inventory consists of the following:

Pre-production section 471 costs in ending inventory	C	$14,000,000
Production section 471 costs in ending inventory	D	$12,000,000
Total section 471 costs in ending inventory	C + D = E	$26,000,000

Using the MSPM ratios above, S calculates its total additional section 263A costs capitalized to ending inventory as follows:

Pre-production section 471 costs in ending inventory	C	$14,000,000
MSPM pre-production ratio	A	5.0000%
Pre-production additional section 263A costs capitalized to ending inventory	C * A = F	$700,000
Production section 471 costs in ending inventory	D	$12,000,000
MSPM production ratio	B	18.0000%
Production additional section 263A costs capitalized to ending inventory	D * B = G	$2,160,000
Total additional section 263A costs capitalized to ending inventory	F + G = H	$2,860,000

S sold resale goods and produced goods to another member of the consolidated group, B, during the year. Under Treas. Reg. § 1.1502-13(b)(2)(ii), S must reduce its intercompany income by the deferred additional section 263A costs related to goods sold to B that remain in B's ending inventory. S computes it deferred additional section 263A costs related to B's ending inventory as follows:

S's resale goods in B's ending inventory (with markup)	I	$2,800,000
Markup included in B's ending inventory	J	$800,000
S's basis in B's ending inventory	I - J = K	$2,000,000
S's MSPM pre-production ratio	A	5.0000%
Deferred additional section 263A costs related to S's resale goods in B's ending inventory	K * A = L	$100,000
S's produced goods in B's ending inventory (with markup)	M	$14,000,000
Markup included in B's ending inventory	N	$4,000,000
S's basis in B's ending inventory	M - N = O	$10,000,000
S's MSPM production ratio	B	18.0000%
Deferred additional section 263A costs related to S's produced goods in B's ending inventory	O * B = P	$1,800,000
Total deferred additional section 263A costs related to S's goods in B's ending inventory	L + P = Q	$1,900,000

B. *Clarify the method changes rules for deferred additional section 263A costs related to intercompany sales of inventory*

Overview

Reg. § 1.263A-7(c)(3) provides that, pursuant to any change in method of accounting for costs subject to section 263A, taxpayers are required to revalue the amount of any intercompany item resulting from the sale or exchange of inventory property in an intercompany transaction to an amount equal to the intercompany item that would have resulted had the cost of goods sold for that inventory property been determined under the taxpayer's new method. The requirement of the preceding sentence applies with respect to both inventory produced by a taxpayer and inventory acquired by the taxpayer for resale. In addition, the requirements of Reg. § 1.263A-7(c)(3) apply only to any intercompany item of the taxpayer as of the beginning of the year of change in method of accounting. See Reg. § 1.1502-13(b)(2)(ii). A taxpayer must revalue the amount of any intercompany item only if the inventory property sold in the intercompany transaction is held as inventory by a buying member as of the date the taxpayer changes its method of accounting under section 263A. Corresponding changes to the adjustment required under section 481(a) must be made with respect to any adjustment of the intercompany item required under Reg. § 1.263A-7(c)(3). Moreover, the requirements of Reg. § 1.263A-7(c)(3) apply regardless of whether the taxpayer has any items in beginning inventory as of the year of change in method of accounting. See § 1.1502-13 for the definition of intercompany transaction.

Recommendation

The AICPA recommends that Treasury and the IRS formalize the automatic change treatment with a section 481(a) adjustment by modifying sections 12.01 and 12.02 of Rev. Proc. 2022-14 to explicitly provide that a change to begin properly accounting for an intercompany item resulting from the sale or exchange of inventory property in an intercompany transaction (e.g., a change to begin properly deferring additional section 263A costs related to intercompany sales of inventory

for goods that remain in the buying member's ending inventory) is an automatic method change and that this change is implemented with a section 481(a) adjustment.

The AICPA also recommends that Treasury and the ISR provide similar rules for taxpayers with separate trades or businesses when one trade or business sells to another trade or business.

Analysis

We are aware of several discussions between one practitioner and the IRS National Office in which the IRS National Office informed the practitioner that a change to begin deferring additional section 263A costs related to intercompany sales of inventory is an automatic change covered by sections 12.01 and 12.02 of Rev. Proc. 2022-14. Furthermore, the IRS National Office informed the practitioner that this change is implemented with a section 481(a) adjustment pursuant to Reg. § 1.263A-7(c)(3). The AICPA agrees that this change should be an automatic change under sections 12.01 and 12.02 of Rev. Proc. 2022-14 and that Reg. § 1.263A-7(c)(3) requires this change to be implemented with a section 481(a) adjustment. However, we are also aware of non-automatic accounting method changes that were filed for this same item where consent was granted by the IRS National Office, and the change was required to be implemented on a cut-off basis. Therefore, clarification is needed to ensure that these method changes are implemented consistently.

9. Provide for a re-election of historic absorption ratio

Overview

Many taxpayers who were required to file a change in accounting method as a result of the 2018 final regulations previously used a HAR to compute the amount of additional section 263A costs required to be capitalized each year. Taxpayers generally use a HAR to allow them to comply with the rules while easing the administrative burden associated with having to prepare a full section 263A calculation each year. However, most taxpayers that used a HAR prior to adopting the 2018 final regulations were unable to continue using a HAR when changing methods to comply with the 2018 final regulations due to the restrictions on electing the HAR and/or the requirement to recompute the HAR using data that may no longer be available.

The HAR rules provided in Reg. § 1.263A-2(b)(4), Reg. § 1.263A-2(c)(4), and Reg. § 1.263A-3(d)(4) generally provide that a taxpayer may elect a HAR only if the taxpayer consistently used a simplified method for three or more consecutive taxable years immediately prior to the year of election, the taxpayer has capitalized additional Section 263A costs using actual absorption ratios for its three most recent consecutive taxable years, and the taxpayer has not obtained the Commissioner's consent to revoke the HAR election within its prior six taxable years.

The government previously provided transition rules in Reg. § 1.263A-2(b)(4)(v) and Reg. § 1.263A-3(d)(4)(v) that permitted taxpayers to elect a HAR in their first, second, or third taxable year beginning after December 31, 1993, and taxpayers were eligible to make an election under these transition rules whether or not they previously used a SPM or SRM. A taxpayer making such an election was required to recompute (or compute) its additional section 263A costs, and thus, its HAR for its first test period as if the rules under section 263A had applied throughout the test period. A similar transition rule for taxpayers changing to the MSPM would allow taxpayers to

immediately elect a HAR and compute it based on the three most recent taxable years using the methods in the 2018 final regulations.

Recommendations

The AICPA recommends that the Treasury and the IRS provide a transition rule that permits taxpayers to adopt the 2018 final regulations and use a HAR method (i.e., MSPM with HAR, SPM with HAR, or SRM with HAR) and compute a new HAR using the three most recent taxable years. Alternatively, we suggest the government provide a transition rule that permits taxpayers to elect HAR after applying a consistent simplified method for three consecutive years, regardless of whether the taxpayer revoked its previous HAR election within the prior six taxable years, in order to provide equitable rules for similarly situated taxpayers.

HAR Transition Rules

Provide transition rules for 2021 and 2022 taxable years similar to those in Reg. § 1.263A-2(b)(4)(v)(A) and Reg. § 1.263A-3(d)(4)(v)(A) to provide:

1. A taxpayer using MSPM is eligible to make a HAR election under the transition rules regardless of whether it used the MSPM in the previous three taxable years. A taxpayer making such an election would recompute (or compute) its additional section 263A costs, and thus, its HAR for its first test period as if the 2018 final regulations had applied throughout the test period.

2. A taxpayer using the SPM with HAR or the SRM with HAR that is changing to comply with the 2018 final regulations is eligible to recompute its additional section 263A costs, and thus, the HAR, using the three most recent taxable years as a new test period as if the 2018 final regulations had applied throughout the test period.

3. A taxpayer that revoked a HAR election in 2018, 2019, or 2020 taxable years in order to comply with the 2018 final regulations is immediately eligible to elect the HAR regardless of the fact that the taxpayer obtained the Commissioner's consent to revoke the HAR election within its prior six taxable years. A taxpayer making such an election would recompute (or compute) its additional section 263A costs, and thus, its HAR for its first test period as if the 2018 final regulations had applied throughout the test period.

Alternatively, if the recommendations above are not adopted, we suggest the government provide transition rules permitting a taxpayer who revoked a HAR election in 2018, 2019, or 2020 taxable years to elect the HAR after using the SPM or SRM for at least 3 taxable years regardless of the fact that the taxpayer obtained the Commissioner's consent to revoke the HAR election within its prior six taxable years. This would put these taxpayers in the same position as taxpayers that changed to the MSPM without the HAR.

Analysis

The 2018 final regulations required a significant majority of taxpayers using the SPM with HAR or the SRM with HAR to change their method of allocating costs to inventory to comply with one or more aspects of the regulations (e.g., new definition of section 471 costs). Many taxpayers would have preferred to continue using the HAR for administrative simplicity but were unable to

because of the excessive administrative burden. Specifically, in order to continue applying the HAR, such taxpayers were required update the HAR by applying the 2018 final regulations to (1) the original test period, (2) all recomputation years, and (3) all updated test periods (see section 12.17 of Rev. Proc. 2022-14).

For example, assume:

- Taxpayer A applied a consistent SPM for the tax years 2009-2011 (the test period).
- For the 2012 tax year, Taxpayer A made a HAR election and properly computed its HAR [as additional section 263A costs incurred during the test period divided by Section 471 costs incurred during the test period]. See Reg. §§ 1.263A-2(b)(4)(ii)(A) and (B).
- Taxpayer A's qualifying period with respect to its HAR election was the period including each of the first five taxable years beginning with the first taxable year after a test period: 2012-2016. See Reg. § 1.263A-2(b)(4)(ii)(C).
- To determine whether there would be an extension of its qualifying period, Taxpayer A computed its actual SPM absorption ratio in 2017. Taxpayer A's actual SPM absorption ratio computed for the 2017 tax year was within one-half of one percentage point of its original HAR. Therefore, Taxpayer A's qualifying period was extended to include the re-computation year (2017) and the following five taxable years: 2018-2022.

In order for Taxpayer A to maintain its HAR election (i.e., to avoid the need to revoke its HAR election or change to a non-HAR method) while implementing changes to comply with the 2018 final regulations (e.g., to comply with new definition of section 471 costs), Taxpayer A would have been required to apply the rules in the 2018 final regulations to (1) recompute the HAR for its original test period (2009-2011), and (2) recompute the actual SPM absorption ratio computed for 2017. This approach would have required Taxpayer A to have access to the underlying detail to support recomputation of the SPM absorption ratios for 2009, 2010, 2011, and 2017, using the rules in the 2018 final regulations. In addition, if the recomputed 2017 SPM absorption ratio differed by more than 0.5% from the recomputed HAR, Taxpayer A would also need the underlying detail for 2018 and 2019.

Many taxpayers elected a HAR in the 1990s or early 2000s, compounding the difficulty in obtaining the detail required to prepare computations using the rules in the 2018 final regulations. Absent the transition rules proposed above, taxpayers that changed to the MSPM would be unable to make a HAR election until after they have used the MSPM for three years. Taxpayers that revoked a HAR election for the 2018, 2019, or 2020 taxable year would have to wait six years to elect HAR again. These requirements are not consistent with the overall simplification the HAR method was intended to provide.

Overall, a transition rule would greatly reduce the administrative burden associated with applying the 2018 final regulations and allow taxpayers using the SPM or SRM that revoked a HAR election to be in the same position as taxpayers that changed to the MSPM.

10. Allow automatic method changes when financial statement calculations change

Overview

Reg. § 1.263A-1(d)(2) defines section 471 costs as the costs capitalized to inventory in the taxpayer's financial statements. Reg. § 1.263A-1(d)(3)(i) defines additional section 263A costs as the costs (other than interest) that are not included in a taxpayer's section 471 costs but that are required to be capitalized under section 263A. Generally, methods of accounting under section 263A require identification of both a taxpayer's section 471 costs and its additional section 263A costs incurred.

It is common for a taxpayer to occasionally change the costs capitalized to inventory for financial statement purposes, which can result in a change to both its section 471 costs and its additional section 263A costs. For example, this can occur if the taxpayer did not include a certain amount in inventory because it was not material but later grew to become material, discovered that a particular cost was inadvertently not capitalized to inventory but should have been, or simply changed its philosophy on a certain category of costs either upon a reevaluation of its accounting policies or a staffing change. In some cases, the section 263A analysis itself uncovers some of these matters which may result in changes to book accounting in the year subsequent to a section 263A accounting method change being made. In some of these examples, a taxpayer may begin to capitalize a cost for financial statement purposes that was previously treated as an additional section 263A cost and now must be treated as a section 471 cost. In other cases, a taxpayer may begin to discontinue capitalizing a cost for financial statement purposes that was previously treated as a section 471 cost and now must be treated as an additional section 263A cost.

Section 12.17 of Rev. Proc. 2022-14 provides an automatic consent method change for taxpayers to recharacterize section 263A costs as section 471 costs (or vice versa) under a simplified method for capitalizing additional section 263A costs. This change contains a waiver of the five-year eligibility rule in section 5.01(1)(f) of Rev. Proc. 2015-13, but only for the first, second, or third tax year ending on or after November 20, 2018. When this waiver period expires, if a taxpayer changes the costs capitalized to inventory for financial statement purposes more than once within a five-year period, the taxpayer would not be eligible to file an automatic method change to comply with the definitions of section 471 costs and additional section 263A costs in the 2018 final regulations.

Often when a taxpayer changes the costs capitalized to inventory for financial statement purposes, the change is implemented on a prospective basis, with no adjustment to the beginning inventory for the year of change. When this occurs, it is nearly impossible to compute a section 481(a) adjustment for the corresponding tax accounting method change. Although the taxpayer may be able to recharacterize the costs incurred during the year for purposes of computing the simplified method absorption ratio(s), the taxpayer is unable to revalue the section 471 costs in beginning inventory to reflect the recharacterization of costs.

Recommendations:

The AICPA recommends that Treasury and the IRS should modify section 12.17 of Rev. Proc. 2022-14 as follows:

- Establish a permanent waiver of the five-year eligibility rule for any changes to recharacterize costs resulting from a change to the costs capitalized to inventory in a taxpayer's financial statements.
- Provide taxpayers with the option to implement changes to recharacterize costs on a cut-off basis or with a section 481(a) adjustment if the taxpayer has adequate detail to accurately compute an adjustment.
- Regarding changes made for financial statement costing of inventory that would not be covered by section 12.17 of Rev. Proc. 2022-14, consider adding an automatic method change to allow taxpayers to conform to the methods used for financial reporting purposes.

Analysis:

If a taxpayer changes its inventory costing for financial statement purposes more than once within a five-year period, the five-year eligibility rule in section 5.01(1)(f) of Rev. Proc. 2015-13 would prohibit the taxpayer from filing more than one automatic method change under section 12.17 of Rev. Proc. 2022-14.

The five-year eligibility rule in Section 5.01(1)(f) of Rev. Proc. 2015-13 is waived for certain automatic method changes. For instance, section 16.10 of Rev. Proc. 2022-14, which addresses changes in revenue recognition to align with the changes a taxpayer makes within its applicable financial statements permanently waives the five-year eligibility rule for certain cost offset method changes. Further, the method changes under section 16.10 of Rev. Proc. 2022-14 illustrate instances where taxpayers may change accounting methods automatically to be consistent with financial reporting. This provides support for allowing taxpayers to make similar changes to inventory where the change is being made for financial reporting purposes. Other automatic changes that permanently waive the five-year eligibility rule include changes under the following sections of Rev. Proc. 2022-14:

2.01	Treating amounts received as loans
4.02	Bank making the conformity election for bad debts
6.01	Impermissible to permissible method for depreciation or amortization
7.01	Change to a different method or different amortization period for research and experimental expenditures under section 174
11.03	Method of accounting for removal costs
12.01(1)(a)(i)	Change from a permissible non-UNICAP method to a permissible UNICAP method for the first tax year that a reseller or reseller-producer does not qualify as a small business taxpayer
12.02(1)(a)(ii)	Change to UNICAP methods specifically described in the regulations in the first tax year that a producer or reseller-producer does not qualify as a small business taxpayer
12.12(2)(a)	Required change in the applicable U.S. trade or business for a foreign person using the U.S. ratio method
12.13	Method of accounting for depletion under section 263A
12.15	Change to not apply section 263A to replanting costs for lost or damaged citrus plants

16.08	Change in AFS for purposes of applying certain revenue recognition methods
20.13(1)	Timing of incurring inventory costs
22.08	Change for rotable spare parts required by section 5.06 of Rev. Proc. 2007-48
23.07(1)(d)	Change to combine or separate pools under a 5 percent pooling rule
23.07(1)(f)	Change in BLS categories for a taxpayer using the 10 percent method
23.07(1)(g)	Change in representative month due to change in tax year or change in method of determining current-year cost
26.04	Change in basis of computing reserves under section 807(f)
30.01	Change to the principal-reduction method for de minimis original issue discount
32.02	Change for stated interest on short-term loans of cash method banks

A similar waiver should be provided for changes under section 12.17 of Rev. Proc. 2022-14.

In addition, as taxpayers make changes to their inventory costing for financial statement purposes, significant difficulty may arise in computing the difference between their present and proposed methods of accounting. Accurate computation of a section 481(a) adjustment may be impractical or impossible, particularly if a change for financial statement reporting purposes is implemented with no adjustment to beginning inventory or is made beyond the beginning of the year. The availability of a method change using a cut-off method would reduce compliance burden in many cases.

Rev. Proc. 2022-14 provides that, for certain automatic method changes, taxpayers may implement the change on a cut-off basis or with a section 481(a) adjustment. For example, a taxpayer making a change under sections 16.08(1)(a)(iii) or (iv) (certain AFS changes for revenue recognition), 16.09 (change in timing for income recognition due to New Standards), 16.10(2)(a)(i) (change to a method of accounting under proposed Reg. § 1.451-3 by an accrual method taxpayer with an AFS for a tax year beginning before January 1, 2021), or 16.10(2)(a)(ii) (change to a method of accounting for advance payments under proposed Reg. §1.451-8(a) or (c) by an accrual method taxpayer with an AFS for a tax year beginning before January 1, 2021) of Rev. Proc. 2022-14 may implement the change with either a section 481(a) adjustment or on a cut-off basis. In addition, section 22.14 of Rev. Proc. 2022-14 provides that taxpayers changing to the rolling-average method to account for inventories generally must implement this change on a cut-off basis, but the taxpayer may choose to implement the change with a section 481(a) adjustment if its books and records contain sufficient information to compute a section 481(a) adjustment. For similar reasons, a taxpayer making a change under section 12.17 of Rev. Proc. 2022-14 should be provided with the option to implement the change on a cut-off basis or with a section 481(a) adjustment if the taxpayer's books and records contain sufficient information to compute a section 481(a) adjustment.

Modifying section 12.17 of Rev. Proc. 2022-14 as described above would greatly reduce compliance burdens and uncertainty for taxpayers.

11. Waive the 5-year eligibility rule for required changes between the alternative method and the default method

Overview

Reg. § 1.263A-(d)(4) defines section 263A costs to include all costs that a taxpayer must capitalize under section 263A, which is the sum of a taxpayer's section 471 costs, its additional section 263A costs, and any interest capitalizable under section 263A(f). Generally, methods of accounting under section 263A require quantifying both a taxpayer's section 471 costs and its additional section 263A costs incurred. Reg. § 1.263A-1(d)(2) provides two methods a taxpayer may utilize to determine section 471 costs for purposes of section 263A calculations, a general (default) method and an alternative method.

Use of the alternative method is available only if a taxpayer's financial statement is described under Reg. § 1.263A-1(d)(6)(i)-(iii), which generally includes only financial statements filed with the SEC, a certified audited financial statement, or a financial statement required to be provided to the federal or state government or any federal or state agency (collectively referred to as an "AFS"). It is common for a taxpayer to have an AFS in one period but not in another, or vice versa. For example, a taxpayer with an AFS may be acquired and there may not be a need to have an audit performed for the period from the beginning of the year through the acquisition date.

If a taxpayer alternates between years with an AFS and years without an AFS, it may be required to change its method of accounting from the alternative method to the default method in one period and may desire to readopt the alternative method shortly thereafter when it is otherwise eligible. Alternating between these methods is incredibly burdensome and would not appear to be necessary since the underlying financial accounting is rarely changing in these windows of time. Additionally, without a waiver of the five-year eligibility rule under these circumstances, these changes often require advance consent.

Recommendation

The AICPA recommends that Treasury and the IRS provide relief for a taxpayer that reasonably anticipates its period without an AFS to not exceed two tax years. In this circumstance, a taxpayer that previously maintained an AFS would be permitted to remain on the alternative method for up to two subsequent tax years without an AFS, and the alternative method would be applied using the taxpayer's books and records in lieu of an AFS.

The AICPA further recommends that the five-year eligibility rule be waived to permit changes between the alternative method and the default method under sections 12.01 and 12.02 of Rev. Proc. 2022-14 for a three-tax year period beginning with the first year that a taxpayer no longer has an AFS.

Analysis

Alternating between the alternative method and the default method when a taxpayer alternates between tax years with an AFS and tax years without an AFS causes substantial burdens on taxpayers. This would require taxpayers to recharacterize costs between additional section 263A costs and section 471 costs, or vice versa. Taxpayers required to recharacterize costs from

additional section 263A costs to section 471 costs under the default method would be required to determine the proper allocation of those section 471 costs. For the reasons stated above, this is very complex for most taxpayers. Therefore, it would be reasonable for a taxpayer to maintain its existing method of accounting if it anticipates having an AFS in the foreseeable future.

A period of no shorter than two tax years without an AFS would seem appropriate for relief because it is common for an acquired business to not have an AFS for the year it is acquired and, in some circumstances, for the year subsequent to the acquisition. For example, a calendar corporation acquired by a newly formed corporate holding company on December 17 may have a short tax year from January 1 through December 17 and a second short tax year from December 18 through December 31. It is common to not have an AFS for the period from January 1 through December 17 because neither the selling shareholders nor the lender in the transaction would require an audit. Further, given that the post-acquisition period is only 2 weeks, it is not uncommon for the company's next AFS to cover the period beginning December 18 through the following December 31, (i.e., an AFS covering ~54 weeks).

In this circumstance, there would be no AFS for two consecutive tax years, but there would be an AFS for the first full calendar year after the acquisition. The taxpayer would likely desire to remain on the alternative method, but under the current regulations, the taxpayer would be required to change from the alternative method to the default method for the year of the acquisition and then could change back to the alternative method for the first full calendar year after the acquisition. However, one or both of these changes may not meet the automatic consent requirements of Rev. Proc. 2015-13 if a section 263A method change was made in the previous 5 tax years (this is certainly true for the second change since a change from the alternative method would have been made for the year of the acquisition).

Therefore, it seems appropriate to permit a taxpayer that previously had an AFS and reasonably anticipates having an AFS again within three years to remain on the alternative method. It would be reasonable to permit the taxpayer to use its books and records as the basis for this method in lieu of an AFS. If in the third year the taxpayer still did not have an AFS, it would be required to switch to the default method. Further, whether or not a taxpayer is permitted to remain on the alternative method under the proposal above, the five-year eligibility rule should be waived for changes to or from the default method to ensure that each of these changes would be permitted on an automatic basis.

12. Clarify how the de minimis rules for uncapitalized costs apply to taxpayers that elect the historic absorption ratio

<u>Overview</u>

Under Reg. § 1.263A-1(d)(2)(iv)(D), a taxpayer that uses the HAR provided in Reg. § 1.263A-2(b)(4) or (c)(4) or Reg. § 1.263A-3(d)(4), and that uses the de minimis rule for uncapitalized direct labor costs and/or the de minimis rule for uncapitalized direct material costs during its test period or updated test period, determines whether direct labor costs or direct material costs, as applicable, are included in any of its section 471 costs remaining on hand at year end during its qualifying period or extended qualifying period according to how those direct labor costs or direct material costs, respectively, are identified in at least two of the three years of the taxpayer's applicable test period or updated test period.

This rule is illustrated in Example 2 under Reg. §1.263A-1(d)(2)(iv)(E), as follows. Taxpayer S uses the HAR provided in Reg. § 1.263A-2(c)(4). S uses the de minimis method of accounting under Reg. § 1.263A-1(d)(2)(iv)(B). S excludes certain uncapitalized direct labor costs from its section 471 costs (and includes them in additional section 263A costs) under Reg. § 1.263A-1(d)(2)(iv)(B) in Years 1 and 3 of its applicable test period. Because S excluded direct labor costs from its section 471 costs in at least two of the three years of its applicable test period, S must exclude those same costs from its pre-production and production section 471 costs remaining on hand at year end during its qualifying period or extended qualifying period.

Reg. § 1.263A-1(d)(2)(v), which provides a safe harbor method for uncapitalized variances and under or over-applied burdens, does not contain a similar rule for a taxpayer that uses the HAR and that uses the safe harbor method for uncapitalized variances and under or over-applied burdens during its test period or updated test period. Therefore, it is unclear how a taxpayer determines whether uncapitalized variances and under or over-applied burdens are included in its section 471 costs remaining on hand at year end during its qualifying period or extended qualifying period if those uncapitalized variances and under or over-applied burdens are not identified consistently in all three years of the taxpayer's applicable test period or updated test period.

Recommendation

The AICPA recommends that Treasury and the IRS clarify that, if a taxpayer uses the HAR and uses the safe harbor method for uncapitalized variances and under or over-applied burdens during its test period or updated test period, the taxpayer determines whether uncapitalized variances and under or over-applied burdens are included in its section 471 costs remaining on hand at year end during its qualifying period or extended qualifying period according to how those uncapitalized variances and under or over-applied burdens are identified in at least two of the three years of the taxpayer's applicable test period or updated test period.

Analysis

As noted above, Reg. § 1.263A-1(d)(2)(iv)(D) provides a specific rule for a taxpayer that uses the HAR and that uses de minimis rule for uncapitalized direct labor costs and/or the de minimis rule for uncapitalized direct material costs during its test period or updated test period if those uncapitalized costs are not identified consistently in all three years of the taxpayer's applicable test period or updated test period. However, it appears that a similar rule was inadvertently omitted under Reg. § 1.263A-1(d)(2)(v) for a taxpayer that uses the HAR and that uses the safe harbor method for uncapitalized variances and under or over-applied burdens during its test period or updated test period. The omission of a similar rule in this circumstance creates uncertainty that can be easily resolved by issuing guidance providing a rule consistent with the rule in Reg. § 1.263A-1(d)(2)(iv)(D) for a taxpayer that uses the HAR and that uses the safe harbor method for uncapitalized variances and under or over-applied burdens during its test period or updated test period.

* * * * *

The AICPA is the world's largest member association representing the accounting profession, with more than 428,000 members in the United States and worldwide, and a history of serving the public interest since 1887. Our members advise clients on federal, state, and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of our recommendations and welcome the opportunity to further discuss our comments. If you have any questions, please contact David Strong, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (616) 752-4251, or david.strong@crowe.com; Elizabeth Young, Senior Manager — AICPA Tax Policy & Advocacy, at (202) 434-9247, or elizabeth.young@aicpa-cima.com; or me at (601) 326-7119 or JanLewis@HaddoxReid.com.

Sincerely,

Jan Lewis, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
The Honorable Lily Batchelder, Assistant Secretary for Tax Policy, Department of the Treasury
Mr. William Paul, Principal Deputy Chief Counsel and Deputy Chief Counsel, Office of Chief Counsel, Internal Revenue Service
Mr. Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury
Ms. Wendy Friese, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Mr. Timothy Powell, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Ms. Julie Hanlon-Bolton, Income Tax & Accounting, Internal Revenue Service
Ms. Karla Meola, Income Tax & Accounting, Internal Revenue Service