American Institute of CPAs
1455 Pennsylvania Avenue, NW
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February 25, 2014

Mr. Andrew Keyso, Jr.
Associate Chief Counsel
Income Tax & Accounting
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Comments on the Proposed Regulations under Section 263A Regarding Negative Additional Section 263A Costs

Dear Mr. Keyso:

The American Institute of Certified Public Accountants (AICPA) appreciates the opportunity to provide comments on the Proposed Regulations under Section 263A Regarding Negative Additional Section 263A Costs (REG-126770-06). These comments were developed by the Negative Additional Section 263A Costs Task Force of the AICPA Tax Methods and Periods Technical Resource Panel, and approved by the AICPA Tax Executive Committee.

The AICPA is the world's largest member association representing the accounting profession, with more than 394,000 members in 128 countries and a 125-year heritage of serving the public interest. 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 have identified a number of key issues in the application of proposed regulations under section 263A regarding negative additional 263A costs. We respectfully request that the Internal Revenue Service and the Department of the Treasury modify the proposed regulations to address these issues with our detailed suggestions below to prevent potential controversy in this area.

* * * * *

We appreciate your consideration of our recommendations and we welcome further discussion. If you have any questions, please contact James Martin, Chair, AICPA Negative Additional 263A Costs Task Force, at (202) 414-1511, or james.e.martin@us.pwc.com; Carol Conjura, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (202) 533-3040, or cconjura@kpmg.com; or Jason Cha, AICPA Technical Manager, at (202) 434-9231, or jcha@aicpa.org.

Respectfully submitted,

Jeffrey A. Porter, CPA
Chair, Tax Executive Committee

cc: Scott Dinwiddie, Special Counsel to the Associate Chief Counsel (Income Tax & Accounting), Internal Revenue Service
Alexa Claybon, Attorney-Advisor, Office of Tax Legislative Counsel, Department of the Treasury
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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Comments on the Proposed Regulations under Section 263A Regarding Negative Additional Section 263A Costs

Developed by the
Negative Additional Section 263A Costs Task Force

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Comments on the Proposed Regulations under Section 263A Regarding Negative Additional Section 263A Costs

Scope of Comments

In a notice of proposed rulemaking (REG-126770-06), the Internal Revenue Service (IRS) and the Department of the Treasury ("Treasury") issued proposed regulations that would affect taxpayers that are required to capitalize costs to property produced or property acquired for resale under section 263A.[1] In particular, under these proposed regulations, a taxpayer generally is not permitted to include "negative amounts" in additional section 263A costs if the taxpayer uses the simplified production method (SPM). The proposed regulations request comments, and the American Institute of Certified Public Accountants (AICPA) is pleased to offer the following comments. For additional background on the treatment of negative amounts under section 263A for taxpayers using the SPM, please see the AICPA's previous comment letter on this subject dated July 17, 2006 (copy attached).

I. Executive Summary

The comments herein include a number of recommendations that the IRS and Treasury should consider before publishing final regulations under section 263A.

First and foremost, the final regulations should allow taxpayers to include negative amounts in additional section 263A costs under the SPM. As explained in more detail below, the proposed regulations reduce the simplicity of the SPM, which diminishes the distinguishing characteristic of the method. The SPM reduces compliance costs for taxpayers and the burden of examining section 263A calculations for the IRS. The SPM is an averaging convention; therefore, it is not a fully precise method. However, under the SPM, all allocated costs flow through the costs of production, and any negative amounts treated as additional section 263A costs reverse over time. Although the SPM is less precise and generally less advantageous than other allocation methods, many taxpayers prefer the SPM because this method is more cost effective to implement and maintain. Furthermore, taxpayers frequently use the SPM when they lack the information or the personnel to prepare a calculation using more favorable allocation methods.

Overall, the changes introduced by the proposed regulations replace a simple and cost effective method of complying with section 263A. The proposed changes make the current method more complex and time-consuming and place additional burdens on many taxpayers, especially small taxpayers. For these reasons, the SPM should remain unchanged, and the final regulations should allow taxpayers to include negative amounts in additional section 263A costs.

[1] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.

In addition, the final regulations should permit the modified simplified production method (MSPM) (with the suggested changes described below) as an elective alternative to the SPM for taxpayers that want to more precisely allocate additional section 263A costs.

However, if the IRS and Treasury conclude that taxpayers must exclude negative amounts from additional 263A costs under the SPM as provided in the proposed regulations, the AICPA recommends the following modifications:

1. Revise the small taxpayer exception, which is based on the section 263A statutory gross receipts test for small resellers. This standard no longer accurately represents a small taxpayer and fails to define a small taxpayer in the context of requiring a change from the SPM due to negative amounts of additional section 263A costs. For purposes of determining eligibility to use the SPM with negative amounts of additional section 263A costs, the final regulations should define a small taxpayer as a taxpayer with an average annual inventory value of $10,000,000 or less. This definition ensures that smaller taxpayers are not subject to the complex, time-consuming allocation requirements set forth in the proposed regulations.

2. Provide that a taxpayer using the proposed MSPM may use any reasonable method to estimate the raw material content of work-in-process (WIP) and finished goods in ending inventory. We are concerned that many taxpayers could not use the proposed MSPM because they are unable to readily identify the raw material costs included in WIP and finished goods on hand at the end of the taxable year (i.e., the raw material content of WIP and finished goods in ending inventory). The ability to use any reasonable method to estimate the raw material content of WIP and finished goods in ending inventory would provide all taxpayers the opportunity to use the proposed MSPM.

3. Modify the proposed MSPM to add a third absorption ratio (the "post-production absorption ratio") to separately allocate post-production additional section 263A costs.[2] As discussed more fully below, the proposed MSPM is potentially distortive. Adding a third absorption ratio to separately allocate post-production additional section 263A costs would allow taxpayers to more precisely allocate positive and negative amounts of additional section 263A costs to the property benefitted from such costs while retaining use of a simplified allocation method. Furthermore, the three-ratio MSPM would add only a minor amount of complexity to the currently proposed MSPM in exchange for a more accurate result.

4. Modify the proposed MSPM to include rules for taxpayers with property produced under contract and property purchased for resale. We make specific recommendations below regarding the treatment of such property under the proposed MSPM (and the three-ratio MSPM).

5. Allow taxpayers to use any reasonable method to allocate capitalizable mixed service costs under the proposed MSPM (or the three-ratio MSPM). The proposed allocation of

[2] For purposes of this comment letter, the MSPM with the additional post-production absorption ratio is referred to as "the three-ratio MSPM."

capitalizable mixed service costs based on direct material costs is distortive in circumstances where the allocation base is unrelated to the capitalizable mixed service costs being allocated. As such, the final regulations should provide that taxpayers using the MSPM (or the three-ratio MSPM) may use any reasonable method to allocate capitalizable mixed service costs between preproduction additional section 263A costs and production additional section 263A costs (and, under the three-ratio MSPM, post-production additional section 263A costs). The discussion below includes two examples of reasonable methods that taxpayers could use to allocate capitalizable mixed service costs.

6. Allow taxpayers to properly apply the proposed MSPM (or the three-ratio MSPM) to last-in, first-out (LIFO) inventory. The proposed regulations include ambiguous language and a cross-reference that, when applied, would provide a result inconsistent with the intent of the proposed rule as illustrated in the applicable example. Therefore, absent a change to the proposed regulations, taxpayers or IRS examiners may interpret the proposed regulations to yield a distortive result.

7. Modify the rules for determining whether the qualifying period related to the historic absorption ratio (HAR) election is extended under the proposed MSPM (or the three-ratio MSPM). We believe the rules provided in the proposed regulations for LIFO inventory should govern all inventory. Consequently, all taxpayers using the proposed MSPM (or the three-ratio MSPM) with a HAR election should compute an actual combined absorption ratio and compare this ratio to the combined HAR to determine if the qualifying period is extended.

8. Provide transition rules for taxpayers that change from the SPM with a HAR election to the proposed MSPM (or the three-ratio MSPM) with a HAR election. These transition rules should require a section 481(a) adjustment and provide specific guidance for implementing the change for LIFO and non-LIFO inventory.

9. Modify the definition of section 471 costs under the proposed regulations. Specifically, the final regulations should eliminate the requirement to treat all direct costs as section 471 costs. Furthermore, the final regulations should provide that only variances capitalized to ending inventory in a taxpayer's financial statements are treated as section 471 costs, and all other variances capitalized under section 263A are treated as additional section 263A costs. Finally, the final regulations should clarify that the ending inventory value subject to section 263A must reflect the methods of accounting used by the taxpayer to value ending inventory for federal income tax purposes.

A more detailed discussion of the above recommendations is included below.

II. Allow Negative Amounts under the SPM

A. Background

Under section 263A, taxpayers are required to capitalize direct and indirect costs that are properly allocable to:

1. Real or tangible personal property produced by the taxpayer, and

2. Real property and personal property described in section 1221(a)(1) acquired by the taxpayer for resale.

Treasury Reg. § 1.263A-1(d)(2)(i) provides that, in general, for purposes of the regulations under section 263A, a taxpayer's section 471 costs are the costs, other than interest, capitalized under its method of accounting immediately prior to the effective date of section 263A.

Treasury Reg. § 1.263A-1(d)(3) generally defines additional section 263A costs as the costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of section 263A, although capitalization of such costs is required under section 263A.

Treasury Reg. § 1.263A-1(f) sets forth various detailed or specific (facts-and-circumstances) cost allocation methods that taxpayers may use to allocate direct and indirect costs to property produced and property acquired for resale. Treasury Reg. § 1.263A-1(g) provides general rules for applying these allocation methods to various categories of costs (i.e., direct materials, direct labor, and indirect costs, including service costs). In addition, in lieu of a facts-and-circumstances allocation method, taxpayers may use the simplified methods provided in Treas. Reg. §§ 1.263A-2(b) and 1.263A-3(d) to allocate direct and indirect costs to eligible property produced or eligible property acquired for resale.

Treasury Reg. § 1.263A-2(b)(3)(i)(A) provides that, in general, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year under the SPM are computed as follows:

Absorption ratio x section 471 costs remaining on hand at year end

Treasury Reg. § 1.263A-2(b)(3)(i)(B) provides that the absorption ratio generally is multiplied by the section 471 costs remaining in ending inventory or otherwise on hand at the end of each taxable year in which the SPM is applied. The resulting product is the additional section 263A costs that are added to the taxpayer's ending section 471 costs to determine the section 263A costs that are capitalized.

Treasury Reg. § 1.263A-2(b)(3)(ii)(A) provides that, under the SPM, the absorption ratio is determined as follows:

$$\frac{\text{Additional Section 263A Costs Incurred During the Year}}{\text{Section 471 Costs Incurred During the Year}}$$

Generally, additional section 263A costs are positive amounts, representing direct and indirect costs where capitalization is required under section 263A that have not been capitalized as section 471 costs. However, negative amounts of additional section 263A costs may arise in several circumstances. For example, negative amounts may exist due to favorable variances under a standard cost or burden rate method. If not capitalized as section 471 costs, taxpayers must capitalize these variances, if significant, as additional section 263A costs.

Negative amounts also can occur when a particular type of cost is capitalized under section 471 when such cost is not capitalized under section 263A. For example, Treas. Reg. § 1.263A-3(c)(4)(vi)(C)(1) provides that capitalizing "pick and pack" costs is not required under section 263A, but some taxpayers capitalize such costs under section 471. Pick and pack costs that are capitalized under section 471 are usually treated as negative additional section 263A costs. In addition, negative amounts of additional section 263A costs may arise due to book-tax differences related to pensions, accrued bonuses, vacation pay, stock options, and depreciation.

As a result, virtually every taxpayer will encounter negative amounts of additional section 263A costs at one time or another.

B. Treatment of Negative Amounts Under the Proposed Regulations

Under the proposed regulations, with a limited exception for small taxpayers, taxpayers are not permitted to include negative amounts in additional section 263A costs under the SPM provided in Treas. Reg. § 1.263A-2(b). Instead, taxpayers precluded from including negative amounts in additional section 263A costs under the SPM are required to choose between the following alternatives:

1. Continue using the SPM, but remove deductible section 471 costs from inventory using a reasonable method that approximates the manner in which the costs were originally capitalized;

2. Use a burden rate method, a standard cost method, or other reasonable facts-and-circumstances method to allocate all additional section 263A costs; or

3. Use the proposed MSPM.

As explained in detail below, none of these alternatives retains the simplicity that was intended in promulgating the SPM.

Removal of Section 471 Costs

Under the proposed regulations, taxpayers that choose to continue using the SPM must remove deductible section 471 costs from ending inventory using a "reasonable manner that approximates the manner in which the taxpayer originally capitalized the costs to its inventory (or other eligible property) in its financial statements." The proposed rule follows the IRS' position, prior to the issuance of Notice 2007-29, that taxpayers must remove deductible section 471 costs from ending inventory in essentially the same manner as those costs were capitalized to the inventory (that is, under the method of accounting used to capitalize section 471 costs).

For example, in TAM 200607021, the IRS held that removing section 471 costs from ending inventory by reducing the numerator of the SPM absorption ratio results in higher costs being removed from ending inventory than were originally capitalized. According to the IRS, the removal of higher costs occurs when the costs are capitalized to different items at different rates under the section 471 method, while the costs are removed from ending inventory based on the overall aggregate percentage of costs remaining in ending inventory under the SPM.

In addition, the proposed regulations do not permit taxpayers to use a top-side or turnover approach to remove deductible section 471 costs from ending inventory. We believe that only a small number of taxpayers have the resources to determine the precise rates at which such costs were originally capitalized as section 471 costs for purposes of removing those costs from ending inventory. For example, cost accountants may adopt a number of different standards or burdens (across a number of different products) to capitalize book depreciation to different items of inventory for financial statement purposes. Under the proposed regulations, in years where book depreciation exceeds tax depreciation, tax departments would have to investigate and determine the rates at which book depreciation was capitalized to different items of inventory throughout the production process in order to correctly remove the excess book depreciation from ending inventory. The tax department would have to perform this analysis not only for depreciation, but for all deductible section 471 costs capitalized to ending inventory for financial statement purposes.

The SPM was designed to avoid this type of detailed and burdensome analysis, which is why many taxpayers subject to section 263A use the SPM. The option to continue using the SPM by removing deductible section 471 costs from ending inventory using a "reasonable manner that approximates the manner in which the taxpayer originally capitalized the costs to its inventory (or other eligible property) in its financial statements" is impractical. Therefore, we believe that only a small number of taxpayers, if any, will apply this approach.

Facts-and-Circumstances Allocation Methods

Taxpayers that choose not to use either the SPM or the proposed MSPM may use a facts-and-circumstances allocation method as described in Treas. Reg. § 1.263A-1(f). As a result, taxpayers may use a specific identification method, a burden rate method, a standard cost method, or any other reasonable method under this section.

With respect to standard cost and burden rate methods, the regulations require that taxpayers allocate costs to property produced or property acquired for resale using predetermined rates. In addition, taxpayers are required to allocate any significant variances to property produced. Implementing a standard cost or burden rate method in accordance with the regulations typically requires coordination with the taxpayer's cost accountants to appropriately determine and allocate costs using predetermined rates. Furthermore, such implementation often requires a new computer system or software. Therefore, taxpayers must make significant investments of time and money to implement a standard cost or burden rate method.

Under the current regulations, taxpayers are permitted to use facts-and-circumstances allocation methods to allocate additional section 263A costs. Using such methods could significantly reduce the amount of additional 263A costs capitalized. Yet, many taxpayers choose to use the SPM to allocate additional 263A costs due to the difficulty of implementing and applying facts-and-circumstances methods. For these same reasons, taxpayers that are no longer permitted to use the SPM due to negative amounts of additional section 263A costs are likely to conclude that changing to a facts-and-circumstances allocation method to allocate additional section 263A costs is not a viable option.

Moreover, the IRS may object to a facts-and-circumstances allocation method on the grounds that the method is not reasonable under Treas. Reg. § 1.263A-1(f)(4) because:

1. The total costs actually capitalized during the year differs from the aggregate costs that are capitalized using another permissible method, or

2. The allocation method is used to circumvent the requirements of the simplified methods.[3]

Thus, we are concerned that the IRS may not accept a variation of the SPM as a reasonable facts-and-circumstances allocation method.

Modified Simplified Production Method

The proposed MSPM is intended to reduce the distortions that may occur by including negative amounts in additional section 263A costs under the SPM. The extent of these distortions under the SPM depends on the nature of the costs and when the costs are incurred in the production process.

Additional 263A costs incurred in the latter stages of production (e.g., storage and handling costs allocable to finished goods) typically do not benefit or relate to unprocessed raw materials. However, the SPM allocates these costs proportionally to all inventories, including unprocessed raw materials. As a result, these costs are over-allocated to ending inventory due to the slower turnover of raw materials. In contrast, costs associated with unprocessed raw materials (e.g., purchasing costs) are over-allocated to cost of goods sold due to the faster turnover of labor and overhead costs.

However, any potential distortion caused by the SPM is not permanent, but is merely a timing item that reverses. For example, under the SPM, excess tax depreciation in the early years of a production asset is allocated proportionally to raw materials, WIP, and finished goods. In this circumstance, the taxpayer will over-allocate the excess tax depreciation to ending inventory. Such over-allocation occurs because production depreciation is allocated to raw materials even though the production depreciation is unrelated to raw materials, and raw materials usually turn over more slowly than labor and overhead costs. However, in the later years of the asset, if the taxpayer treats the excess book depreciation as a negative amount of additional section 263A costs under the SPM, the taxpayer will remove more production depreciation from ending inventory than was capitalized for the year. Thus, a taxpayer that capitalizes production or post-production depreciation under the SPM would over-allocate positive amounts related to excess tax depreciation in the earlier years but would also over-allocate negative amounts related to excess book depreciation in later years. Eventually, the over-allocation of positive amounts is reversed by the over-allocation of negative amounts.

The proposed MSPM purports to reduce the distortions that occur with negatives amounts under the SPM by splitting the SPM formula into:

[3] See TAM 9717002, TAM 9821001, TAM 200144003, and TAM 200437035.

1. A raw material turnover ratio (the preproduction absorption ratio), and

2. A labor and overhead turnover ratio (the production absorption ratio).

Under the proposed MSPM, taxpayers are permitted to include negative amounts in the numerator of both ratios. The IRS and Treasury reason that a fewer distortions will occur because the negative amounts are more precisely allocated between raw materials and labor and overhead.

We agree that the proposed MSPM generally results in fewer distortions and more accurately allocates additional section 263A costs (including negative amounts) than the SPM. However, the proposed MSPM would place a significant administrative burden on some taxpayers because it will require more time, resources, and record keeping than the SPM. This burden outweighs the benefit of reducing the distortions that may occur under the less precise SPM. Moreover, the SPM is equally distortive for positive amounts, yet the IRS and Treasury are focused only on distortions caused by using the SPM to allocate negative, not positive, amounts.

C. AICPA Recommendations

For the reasons discussed above, the final regulations should specifically allow all taxpayers to include negative amounts in additional section 263A costs under the SPM.

Furthermore, as discussed in more detail below, the final regulations should provide all taxpayers with the option to use the more precise (but more complex) MSPM, with the changes proposed below.

III. Exception for Small Taxpayers

As noted above, the proposed regulations provide a general rule that a taxpayer may not include negative amounts in additional section 263A costs under the SPM provided in Treas. Reg. § 1.263A-2(b). However, the proposed regulations provide an exception allowing small taxpayers to include negative amounts in additional section 263A costs under the SPM. For this purpose, a taxpayer is a small taxpayer if its (or its predecessors') average annual gross receipts for the three previous taxable years (test period) do not exceed $10,000,000. The provisions of Treas. Reg. § 1.263A-3(b) apply for purposes of determining the amount of a taxpayer's gross receipts and the test period.

The AICPA agrees that the final regulations should provide an exception for small taxpayers if taxpayers are not permitted to include negative amounts in additional section 263A costs under the SPM. However, in this circumstance, a factor other than gross receipts should be used to define a small taxpayer. The proposed exception is based on the section 263A statutory gross receipts test for small resellers, which provides an exemption from section 263A. However, this standard is almost 30 years old and thus, the gross receipts test no longer accurately represents a small taxpayer. Moreover, it fails to address a small producing taxpayer in the context of what the exception relates to, namely, ending inventory. For example, a taxpayer with gross receipts derived from activities in the ordinary course of business other than the sale of inventory (e.g., service, lease, or royalty revenue) could have average annual gross receipts

for the test period that significantly exceed $10,000,000, while its average ending inventory for the test period is only $2,000,000 or less.

Therefore, the final regulations should provide that a taxpayer is a small taxpayer for purposes of determining eligibility to use the SPM with negative amounts of additional section 263A costs if the average value of its (or its predecessors') ending inventory for the current year and the two previous taxable years (test period) does not exceed $10,000,000. We believe that the average value of ending inventory provides a more accurate representation of a small taxpayer because of a direct correlation between the value of ending inventory and the amount of costs capitalized to ending inventory under the SPM. For this purpose, a taxpayer would determine the value of ending inventory under its methods of accounting for inventory for federal income tax purposes. For LIFO inventory, a taxpayer would determine the value of ending inventory using the current-year cost of the inventory, including any adjustments for trade discounts, cash discounts, and inventory shrinkage. In addition, taxpayers would apply aggregation and test period rules similar to the rules applicable to gross receipts under Treas. Reg. § 1.263A-3(b).

If the average aggregate value of a taxpayer's ending inventory during the test period does not exceed $10,000,000, we believe that including negative amounts in additional section 263A costs under the SPM would not result in a significant distortion. Furthermore, the difference between the amount of additional section 263A costs capitalized to ending inventory under the SPM and the amount of additional section 263A costs capitalized to ending inventory under the proposed MSPM is immaterial when the average aggregate value of a taxpayer's ending inventory during the test period does not exceed $10,000,000.

Therefore, the final regulations should allow a taxpayer to include negative amounts in additional section 263A costs under the SPM if the average aggregate value of its (or its predecessors') ending inventory during the test period does not exceed $10,000,000.

IV. Allow Taxpayers to Use the Proposed MSPM and to Estimate the Raw Material Content of WIP and Finished Goods

Under the proposed regulations, large taxpayers with negative amounts of additional section 263A costs are prohibited from using the SPM. Instead, the proposed regulations provide a new simplified method, the MSPM, under which taxpayers are permitted to include negative amounts in additional section 263A costs. Under the proposed MSPM, a taxpayer's additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year are equal to its allocable preproduction additional section 263A costs plus its allocable production additional section 263A costs.

To determine allocable preproduction additional section 263A costs, the taxpayer must calculate a preproduction absorption ratio equal to preproduction additional section 263A costs divided by raw material section 471 costs.[4] Generally, preproduction additional section 263A costs include indirect costs incurred during the taxable year that are allocable to property held

[4] The proposed regulations refer to "raw material costs," but we believe the phrase "raw material section 471 costs" is a more appropriate description of the denominator of the preproduction absorption ratio.

for future production, even though production has not begun, to the extent the costs are not treated as section 471 costs. Examples of indirect costs allocable to property held for future production include design costs, sourcing costs, purchasing costs, raw material storage costs, and raw material handling costs. In addition, preproduction additional section 263A costs include an allocable portion of capitalizable mixed service costs.

Raw material section 471 costs are defined as the direct costs of acquiring raw materials that a taxpayer purchases during its current taxable year. The preproduction absorption ratio is multiplied by the taxpayer's raw material section 471 costs incurred during the taxable year and remaining on hand at year end. For this purpose, raw material section 471 costs incurred during the taxable year and remaining on hand at year end include not only the direct costs of unprocessed raw materials, but also the raw material costs included in WIP and finished goods (i.e., the raw material content of WIP and finished goods).

To determine allocable production additional section 263A costs under the proposed MSPM, the taxpayer must calculate a production absorption ratio equal to production additional section 263A costs divided by production section 471 costs. For this purpose, production additional section 263A costs are all additional section 263A costs incurred during the taxable year that are not preproduction additional section 263A costs. Production additional section 263A costs include post-production additional section 263A costs (e.g., storage and handling costs allocable to finished goods). In addition, production additional section 263A costs include an allocable portion of capitalizable mixed service costs.

Production section 471 costs are defined as the total section 471 costs that a taxpayer incurs during its current taxable year less the taxpayer's raw material costs. In other words, production section 471 costs are equal to section 471 labor and overhead costs incurred by the taxpayer during the taxable year. The production absorption ratio is multiplied by the taxpayer's production section 471 costs incurred during the taxable year and remaining on hand at year end. For this purpose, production section 471 costs incurred during the taxable year and remaining on hand at year end exclude all raw material costs (i.e., the costs of unprocessed raw materials, as well as the raw material content of WIP and finished goods). Therefore, the production absorption ratio is applied only to the taxpayer's section 471 labor and overhead costs incurred during the taxable year and remaining on hand at year end.

A. Allow Taxpayers to Use the Proposed MSPM

For many years, tax practitioners and taxpayers have expressed the concern that the SPM tends to capitalize an excessive amount of additional 263A costs because, under the SPM, production and post-production additional section 263A costs are allocated to raw materials that have not yet entered the production process. The proposed MSPM alleviates this concern by allocating only preproduction costs to unprocessed raw materials. The proposed regulations would force many taxpayers to change to the proposed MSPM because they could no longer use the SPM due to negative amounts of additional section 263A costs. However, even if taxpayers are permitted to include negative amounts in additional section 263A costs under the SPM, as proposed above, all taxpayers should have the option to use the proposed MSPM (with the changes recommended below) because this method more accurately allocates additional section 263A costs to the property benefitted by the costs.

B. Allow Taxpayers to Estimate the Raw Material Content of WIP and Finished Goods

As noted above, we believe that all taxpayers should have the option to use the proposed MSPM. However, we are concerned that many taxpayers could not use the method because they are unable to readily identify the raw material content of WIP and finished goods in ending inventory. In fact, many taxpayers would have to modify their books and records or purchase a new computer system to track the raw material content of WIP and finished goods in ending inventory in order to change to the proposed MSPM.

The excessive costs of implementing such a system is an unfair burden on taxpayers, especially smaller taxpayers. Therefore, the final regulations should clarify that a taxpayer may use any reasonable method to estimate the raw material content of WIP and finished goods in ending inventory. We offer the following example of a reasonable method that a taxpayer may use to estimate the raw material content of WIP and finished goods in ending inventory.

Example 1 – Reasonable Method of Estimating the Raw Material Content of WIP and Finished Goods under the Proposed MSPM.

Company A uses the first-in, first-out (FIFO) inventory method. Company A incurred the following section 471 costs during the year:

Raw Material Purchases	$20,000,000
Production Labor and Overhead Costs	$30,000,000
Total Section 471 Costs	$50,000,000

The following section 471 costs incurred during the year remain in Company A's ending inventory:

Unprocessed Raw Materials Ending Inventory	$3,500,000
WIP Ending Inventory	$3,600,000
Finished Goods Ending Inventory	$10,900,000
Total Section 471 Costs in Ending Inventory	$18,000,000

Company A incurred the following additional section 263A costs during the year:

Preproduction Additional Section 263A Costs	$200,000
Production Additional Section 263A Costs	$2,700,000
Post-Production Additional Section 263A Costs	$2,100,000
Total Additional Section 263A Costs	$5,000,000

Company A uses a reasonable method to estimate the raw material content of WIP and finished goods in ending inventory based on the percentage of raw material purchases during the taxable year to total section 471 costs incurred during the taxable year.

$$\frac{\text{Raw Material Purchases During the Year}}{\text{Total Section 471 Costs Incurred During the Year}} = \text{Estimated Raw Material Content Percentage}$$

$$\frac{\$20,000,000}{\$50,000,000} = 40\%$$

$$\text{WIP Ending Inventory} \times \text{Estimate Raw Material Content Percentage} = \text{Estimate Raw Material Content of WIP}$$

$\$3,600,000 \times 40\% = \$1,440,000$

$$\text{Finished Goods Ending Inventory} \times \text{Estimate Raw Material Content Percentage} = \text{Estimate Raw Material Content of Finished Goods}$$

$\$10,900,000 \times 40\% = \$4,360,000$

Therefore, Company A's estimated raw material section 471 costs incurred during the year and remaining on hand at year end is computed as follows:

Unprocessed Raw Materials	$3,500,000
Estimated Raw Material Content of WIP	$1,440,000
Estimated Raw Material Content of Finished Goods	$4,360,000
Estimated Raw Material Section 471 Costs Incurred During the Year and Remaining on Hand at Year End	$9,300,000

Company A's estimated production section 471 costs incurred during the year and remaining on hand at year end is computed as follows:

WIP Ending Inventory	$3,600,000	
Less: Estimated Raw Material Content of WIP	($1,440,000)	
Estimated Labor and Overhead Content of WIP		$2,160,000
Finished Goods Ending Inventory	$10,900,000	
Less: Estimated Raw Material Content of WIP	($4,360,000)	
Estimated Labor and Overhead Content of Finished Goods		$6,540,000
Estimated Production Section 471 Costs Incurred During the Year and Remaining on Hand at Year End		$8,700,000

Under the proposed MSPM, Company A computes the preproduction absorption ratio and the allocable preproduction additional section 263A costs as follows:

Preproduction Additional Section 263A Costs Incurred During the Year	=	Preproduction Absorption Ratio
Raw Material Section 471 Costs Incurred During the Year		

$$\frac{\$200,000}{\$20,000,000} = .01$$

Preproduction Absorption Ratio	x	Raw Material Section 471 Costs Incurred During the Year and Remaining on Hand at Year End*	=	Allocable Preproduction Additional Section 263A Costs

* Includes unprocessed raw materials and estimated raw material content of WIP and finished goods.

.01 x $9,300,000 = $93,000

Under the proposed MSPM, Company A computes the production absorption ratio and the allocable production additional section 263A costs as follows:

Production Additional Section 263A Costs Incurred During the Year*	=	Production Absorption Ratio
Production Section 471 Costs Incurred During the Year**		

* Includes production and post-production additional section 263A costs.

** Includes production labor and overhead costs only.

$$\frac{\$4,800,000}{\$30,000,000} = .16$$

Production Absorption Ratio	x	Production Section 471 Costs Incurred During the Year and Remaining on Hand at Year End*	=	Allocable Production Additional Section 263A Costs

* Includes estimated production labor and overhead costs only.

.16 x $8,700,000 = $1,392,000

Company A computes the total allocable additional section 263A costs under the proposed MSPM as follows:

Allocable Preproduction Additional Section 263A Costs	$93,000
Allocable Production Additional Section 263A Costs	$1,392,000
Total Allocable Additional Section 263A Costs	$1,485,000

V. Revise the Proposed MSPM to Add a Post-Production Absorption Ratio

As noted above, under the proposed MSPM, production additional section 263A costs include post-production additional section 263A costs (e.g., storage and handling costs allocable to finished goods). We believe that such inclusion results in several potential distortions.

First, post-production additional section 263A costs relate not only to production section 471 costs (i.e., section 471 labor and overhead costs) in finished goods, but also to raw material section 471 costs in finished goods. In other words, post-production additional section 263A costs relate to the total section 471 costs of finished goods ("finished goods section 471 costs"). Under the proposed MSPM, post-production additional section 263A costs are included in the numerator of the production absorption ratio. However, the denominator of the production absorption ratio does not include total finished goods section 471 costs because raw material section 471 costs in finished goods are excluded. As a result, the production absorption ratio is too high.

In addition, post-production additional section 263A costs are not properly allocated to finished goods in ending inventory under the proposed MSPM because the production absorption ratio is applied only to production section 471 costs (i.e., section 471 labor and overhead costs) incurred during the taxable year and remaining on hand at year end. Instead, the production absorption ratio should be applied to total finished goods section 471 costs incurred during the year and remaining on hand at year end to properly allocate post-production additional section 263A costs to finished goods in ending inventory. Furthermore, the MSPM, as currently proposed, could cause distortions in the allocation of additional section 263A costs to property produced under contract for the taxpayer and property purchased for resale by the taxpayer.[5]

To prevent the potential distortions described above, we recommend modifying the proposed MSPM by adding a third ratio (the "post-production absorption ratio") to allocate post-production additional section 263A costs to finished goods in ending inventory. Using three ratios under the MSPM (hereinafter referred to as "the three-ratio MSPM") would give taxpayers the ability to more precisely allocate positive and negative amounts of additional section 263A costs to the property benefitted by the costs within the framework of a simplified method.

The numerator of the post-production absorption ratio would equal post-production additional section 263A costs incurred during the taxable year allocable to finished goods. The denominator of the post-production absorption ratio would equal total section 471 costs incurred during the taxable year, less unprocessed raw materials on hand at year end and WIP

[5] See section VI below for a discussion of the treatment of storage and handling costs allocable to property produced under contract for the taxpayer and/or property purchased for resale by the taxpayer.

on hand at year end, plus finished goods section 471 costs on hand at the beginning of the taxable year. The denominator of the post-production absorption ratio excludes unprocessed raw materials on hand at year end and WIP on hand at year end because post-production additional section 263A costs relate solely to finished goods. The denominator of the post-production absorption ratio includes finished goods section 471 costs on hand at the beginning of the taxable year because post-production costs have been incurred with respect to such goods and are allocable to such goods. The inclusion of finished goods section 471 costs on hand at the beginning of the taxable year in the denominator of the post-production absorption ratio is similar to the inclusion of beginning inventory in the denominator of the storage and handling costs absorption ratio under the SRM.[6]

Under the three-ratio MSPM, allocable post-production additional section 263A costs would equal the post-production absorption ratio multiplied by finished goods section 471 costs incurred during the taxable year and remaining on hand at year end.

Under the three-ratio MSPM, a taxpayer's total additional section 263A costs allocable to ending inventory would equal the sum of its allocable preproduction additional section 263A costs, its allocable production additional section 263A costs, and its allocable post-production additional section 263A costs.

The following example compares the SPM, the proposed MSPM, and the three-ratio MSPM.

Example 2 – Comparison of the SPM, the Proposed MSPM, and the Three-Ratio MSPM.

Company B uses the FIFO inventory method. Company B incurred the following section 471 costs during the year:

Raw Material Purchases	$60,000,000
Production Labor and Overhead Costs	$76,000,000
Total Section 471 Costs	$136,000,000

Company B determines that the following section 471 costs incurred during the year remain in its ending inventory:

[6] Under the SRM, a taxpayer using the dollar-value LIFO method must include the LIFO value, rather than the current (e.g., FIFO) cost, of beginning inventory in the denominator of the storage and handling costs absorption ratio. We believe that including the current cost of finished goods on hand at the beginning of the taxable year in the denominator of the post-production absorption ratio will provide a more accurate result, even if a taxpayer is using the dollar-value LIFO method. In fact, a producer using the dollar-value LIFO method typically does not calculate a separate LIFO value for finished goods because finished goods are included in a natural business unit pool along with raw materials and WIP. Therefore, the final regulations should permit a producer using the dollar-value LIFO method to use the current (e.g., FIFO) cost of finished goods on hand at the beginning of the taxable year in the denominator of the post-production absorption ratio because the current cost is the only value available to the taxpayer. Furthermore, we recommend that the IRS and Treasury revise the storage and handling costs absorption ratio under the SRM to provide that a taxpayer using the dollar-value LIFO method would use the current (e.g., FIFO) cost of beginning inventory, rather than the LIFO value of beginning inventory, in the denominator of the ratio.

	Total	Raw Material Costs	Labor and Overhead Costs
Unprocessed Raw Materials Ending Inventory	$6,000,000	$6,000,000	
WIP Ending Inventory	$7,200,000	$4,000,000	$3,200,000
Finished Goods Ending Inventory	$22,800,000	$10,000,000	$12,800,000
Total Section 471 Costs in Ending Inventory	$36,000,000	$20,000,000	$16,000,000

Company B capitalizes all storage and handling costs allocable to finished goods, including pick and pack costs, for financial statement purposes. Company B is not required to capitalize its pick and pack costs under section 263A. Therefore, Company B's post-production additional section 263A costs include a negative amount for pick and pack costs.

Company B incurred the following additional section 263A costs during the year:

Preproduction Additional Section 263A Costs	$852,000
Production Additional Section 263A Costs	$5,244,000
Post-Production Additional Section 263A Costs	($1,064,000)
Total Additional Section 263A Costs	$5,032,000

The FIFO value of Company B's finished goods in beginning inventory was $17,200,000.

SPM

Under the SPM, Company B computes the absorption ratio and the allocable additional section 263A costs as follows:

$$\frac{\text{Additional Section 263A Costs Incurred During the Year}}{\text{Section 471 Costs Incurred During the Year}} = \text{Absorption Ratio}$$

$$\frac{\$5,032,000}{\$136,000,000} = .037$$

$$\text{Absorption Ratio} \times \text{Section 471 Costs Incurred During the Year and Remaining on Hand at Year End} = \text{Allocable Additional Section 263A Costs}$$

$$.037 \times \$36,000,000 = \$1,332,000$$

Proposed MSPM

Under the proposed MSPM, Company B computes the preproduction absorption ratio and the allocable preproduction additional section 263A costs as follows:

Preproduction Additional Section 263A Costs Incurred During the Year / Raw Material Section 471 Costs Incurred During the Year	=	Preproduction Absorption Ratio

$\frac{\$852,000}{\$60,000,000} = .0142$

Preproduction Absorption Ratio	x	Raw Material Section 471 Costs Incurred During the Year and Remaining on Hand at Year End*	=	Allocable Preproduction Additional Section 263A Costs

* Includes unprocessed raw materials and raw material content of WIP and finished goods.

.0142 x $20,000,000 = $284,000

Under the proposed MSPM, Company B computes the production absorption ratio and the allocable production additional section 263A costs as follows:

Production Additional Section 263A Costs Incurred During the Year* / Production Section 471 Costs Incurred During the Year**	=	Production Absorption Ratio

* Includes production and post-production additional section 263A costs.

** Includes production labor and overhead costs only.

$\frac{\$4,180,000}{\$76,000,000} = .055$

Production Absorption Ratio	x	Production Section 471 Costs Incurred During the Year and Remaining on Hand at Year End*	=	Allocable Production Additional Section 263A Costs

* Includes production labor and overhead costs only.

.055 x $16,000,000 = $880,000

Company B computes the total allocable additional section 263A costs under the proposed MSPM as follows:

Allocable Preproduction Additional Section 263A Costs	$284,000
Allocable Production Additional Section 263A Costs	$880,000
Total Allocable Additional Section 263A Costs	$1,164,000

Three-Ratio MSPM

Under the three-ratio MSPM, Company B computes the preproduction absorption ratio and the allocable preproduction additional section 263A costs as follows:

$$\frac{\text{Preproduction Additional Section 263A Costs Incurred During the Year}}{\text{Raw Material Section 471 Costs Incurred During the Year}} = \text{Preproduction Absorption Ratio}$$

$$\frac{\$852,000}{\$60,000,000} = .0142$$

$$\text{Preproduction Absorption Ratio} \times \text{Raw Material Section 471 Costs Incurred During the Year and Remaining on Hand at Year End*} = \text{Allocable Preproduction Additional Section 263A Costs}$$

* Includes unprocessed raw materials and raw material content of WIP and finished goods.

$.0142 \times \$20,000,000 = \$284,000$

Under the three-ratio MSPM, Company B computes the production absorption ratio and the allocable production additional section 263A costs as follows:

$$\frac{\text{Production Additional Section 263A Costs Incurred During the Year*}}{\text{Production Section 471 Costs Incurred During the Year**}} = \text{Production Absorption Ratio}$$

* Excludes post-production additional section 263A costs.

** Includes production labor and overhead costs only.

$$\frac{\$5,244,000}{\$76,000,000} = .069$$

$$\text{Production Absorption Ratio} \times \text{Production Section 471 Costs Incurred During the Year and Remaining on Hand at Year End*} = \text{Allocable Production Additional Section 263A Costs}$$

* Includes production labor and overhead costs only.

.069 x $16,000,000 = $1,104,000

Under the three-ratio MSPM, Company B computes the post-production absorption ratio and allocable post-production additional section 263A costs as follows:

$$\frac{\text{Post-Production Additional Section 263A Costs Incurred During the Year}}{\text{Total Section 471 Costs Incurred During the Year – Unprocessed Raw Materials on Hand at Year End – WIP on Hand at Year End + Finished Goods on Hand at the Beginning of the Year}} = \text{Post-Production Absorption Ratio}$$

$$\frac{(\$1,064,000)}{\$140,000,000^*} = (.0076)$$

* $136,000,000 – $6,000,000 – $7,200,000 + $17,200,000 = $140,000,000

Post-Production Absorption Ratio x Finished Goods Section 471 Costs Incurred During the Year and Remaining on Hand at Year End = Allocable Post-Production Additional Section 263A Costs

(.0076) x $22,800,000 = ($173,280)

Company B computes the total allocable additional section 263A costs under the three-ratio MSPM as follows:

Allocable Preproduction Additional Section 263A Costs	$284,000
Allocable Production Additional Section 263A Costs	$1,104,000
Allocable Post-Production Additional Section 263A Costs	($173,280)
Total Allocable Additional Section 263A Costs	$1,214,720

We note that a significant amount of controversy has existed between taxpayers and the IRS because the SRM uses a combined ratio that includes beginning inventory in the denominator of the storage and handling costs absorption ratio. As a result, the amount of capitalized additional section 263A costs under the SRM is usually lower when compared to the SPM. Therefore, taxpayers generally prefer to treat themselves as resellers rather than producers under section 263A.

However, the three-ratio MSPM would diminish the importance of the distinction between a producer and a reseller under section 263A because a reseller could generally use the three-ratio MSPM to reach the same result as the SRM. Under the three-ratio MSPM, the preproduction absorption ratio is equivalent to the purchasing costs absorption ratio under the SRM, and the post-production absorption ratio is generally equivalent to the storage and

handling costs absorption ratio under the SRM.[7] For a reseller with no production activities, the production absorption ratio is zero. Furthermore, a reseller would apply the preproduction absorption ratio and the post-production absorption ratio to the same amount of ending inventory. Therefore, a reseller generally would compute the same amount of total additional section 263A costs allocable to ending inventory under the three-ratio MSPM and the SRM.[8]

As a result, the three-ratio MSPM could significantly reduce controversy related to whether a taxpayer is a producer or a reseller under section 263A.

VI. Rules for Property Produced Under Contract for the Taxpayer and Property Purchased for Resale by the Taxpayer

The final regulations should include rules under the MSPM[9] for taxpayers with property produced under contract and/or property purchased for resale.

Specifically, the final regulations should clarify that, for purposes of the preproduction absorption ratio, raw materials also include all property produced under contract for the taxpayer and/or property purchased for resale by the taxpayer, regardless of whether or not the taxpayer engages in any additional production activities for such property. Therefore, raw material section 471 costs include the direct costs of acquiring any property produced under contract for the taxpayer and the direct costs of acquiring any property purchased for resale by the taxpayer. Furthermore, raw material section 471 costs incurred during the taxable year and remaining on hand at year end include any property produced under contract for the taxpayer during the taxable year and remaining on hand at year end and any property purchased for resale by the taxpayer during the taxable year and remaining on hand at year end.

In addition, the final regulations should clarify that preproduction additional section 263A costs include indirect costs allocable to property produced under contract for the taxpayer and/or property purchased for resale by the taxpayer that are incurred prior to acquisition of such property (e.g., design costs, sourcing costs, purchasing costs), to the extent the costs are not already capitalized as section 471 costs. Under the MSPM, if the taxpayer does not engage in any additional production activities for such property, the taxpayer should treat all storage and handling costs allocable to the property as preproduction additional section 263A costs, to the extent the costs are not already capitalized as section 471 costs. If the taxpayer engages in

[7] For a taxpayer using the LIFO method, however, the result is not the same under the SRM. Under the SRM, a taxpayer using the dollar-value LIFO method must use the LIFO value, rather than the current (e.g., FIFO) cost, of beginning inventory in the denominator of the storage and handling costs absorption ratio. Under the three-ratio MSPM, the current cost of finished goods in beginning inventory is used in the denominator of the post-production absorption ratio, even if the taxpayer is using the dollar-value LIFO method. Therefore, for a taxpayer using the dollar-value LIFO method, the post-production absorption ratio is not equivalent to the storage and handling costs absorption ratio under the SRM. However, we believe that including the current cost of finished goods in beginning inventory in the denominator of the post-production absorption ratio will provide a more accurate result, even if a taxpayer is using the dollar-value LIFO method. Furthermore, we recommend that the IRS and Treasury revise the storage and handling costs absorption ratio under the SRM to provide that a taxpayer using the dollar-value LIFO method would use the current (e.g., FIFO) cost of beginning inventory, rather than the LIFO value of beginning inventory, in the denominator of the ratio.

[8] See footnote 6 above.

[9] Except as otherwise stated, the same rules would apply under the three-ratio MSPM.

any additional production activities for such property, the taxpayer should treat preproduction storage and handling costs allocable to the property as preproduction additional section 263A costs, to the extent the costs are not already capitalized as section 471 costs. Furthermore, the taxpayer should treat post-production storage and handling costs allocable to the property as production additional section 263A costs, to the extent the costs are not already capitalized as section 471 costs.

Under the three-ratio MSPM, the taxpayer should treat property produced under contract for the taxpayer and/or property purchased for resale by the taxpayer as raw materials for purposes of the preproduction absorption ratio. In addition, the taxpayer should treat such property as finished goods for purposes of the post-production absorption ratio. Therefore, total section 471 costs incurred during the taxable year and finished goods section 471 costs on hand at the beginning of the taxable year would include such property. Under the three-ratio MSPM, if the taxpayer does not engage in any additional production activities for such property, the taxpayer should treat all storage and handling costs allocable to the property as post-production additional section 263A costs, to the extent the costs are not already capitalized as section 471 costs. If the taxpayer engages in any additional production activities for such property, the taxpayer should treat preproduction storage and handling costs allocable to the property as preproduction additional section 263A costs, to the extent the costs are not already capitalized as section 471 costs. Furthermore, the taxpayer should treat post-production storage and handling costs allocable to the property as post-production additional section 263A costs, to the extent the costs are not already capitalized as section 471 costs.

Example 3 – Applying the three-ratio MSPM to property produced under contract for the taxpayer and property purchased for resale by the taxpayer.

Company C uses the FIFO inventory method. Company C does not engage in any additional production activities for property produced under contract for Company C and property purchased for resale by Company C. Company C uses the three-ratio MSPM. Company C incurred the following section 471 costs during the year:

Raw Material Purchases	$50,000,000
Production Labor and Overhead Costs	$40,000,000
Property Produced Under Contract for Company C	$6,000,000
Property Purchased for Resale by Company C	$2,000,000
Total Section 471 Costs	$98,000,000

Company C determines that the following section 471 costs incurred during the year remain in its ending inventory:

	Total	Raw Material Costs	Labor and Overhead Costs
Ending Inventory – Unprocessed Raw Materials	$11,000,000	$11,000,000	
Ending Inventory – WIP	$10,000,000	$6,000,000	$4,000,000
Ending Inventory – Produced Finished Goods	$24,100,000	$12,500,000	$11,600,000
Ending Inventory – Property Produced Under Contract for Company C	$2,000,000	$2,000,000	
Ending Inventory – Property Purchased for Resale by Company C	$500,000	$500,000	
Total Section 471 Costs in Ending Inventory	$47,600,000	$32,000,000	$15,600,000

Company C incurred the following additional section 263A costs during the year:

Preproduction Additional Section 263A Costs*	$1,165,800
Production Additional Section 263A Costs	$3,600,000
Post-Production Additional Section 263A Costs**	$4,064,000
Total Additional Section 263A Costs	$8,829,800

* Includes preproduction additional section 263A costs allocable to property produced under contract for Company C and property purchased for resale by Company C.

** Includes storage and handling costs allocable to property produced under contract for Company C and property purchased for resale by Company C.

The FIFO value of Company C's finished goods in beginning inventory, including property produced under contract for Company C and property purchased for resale by Company C, was $50,000,000.

Under the three-ratio MSPM, Company C computes the preproduction absorption ratio and the allocable preproduction additional section 263A costs as follows:

$$\frac{\text{Preproduction Additional Section 263A Costs Incurred During the Year}}{\text{Raw Material Section 471 Costs Incurred During the Year*}} = \text{Preproduction Absorption Ratio}$$

* Includes raw material purchases, property produced under contract for Company C, and property purchased for resale by Company C.

$$\frac{\$1,165,800}{\$58,000,000} = .0201$$

Preproduction Absorption Ratio	x	Raw Material Section 471 Costs Incurred During the Year and Remaining on Hand at Year End*	=	Allocable Preproduction Additional Section 263A Costs

* Includes unprocessed raw materials, raw material costs in WIP and finished goods, property produced under contract for Company C, and property purchased for resale by Company C.

.0201 x $32,000,000 = $643,200

Under the three-ratio MSPM, Company C computes the production absorption ratio and the allocable production additional section 263A costs as follows:

$$\frac{\text{Production Additional Section 263A Costs Incurred During the Year*}}{\text{Production Section 471 Costs Incurred During the Year**}} = \text{Production Absorption Ratio}$$

* Excludes post-production additional section 263A costs.

** Includes production labor and overhead costs only.

$$\frac{\$3,600,000}{\$40,000,000} = .09$$

Production Absorption Ratio	x	Production Section 471 Costs Incurred During the Year and Remaining on Hand at Year End*	=	Allocable Production Additional Section 263A Costs

* Includes production labor and overhead costs only.

.09 x $15,600,000 = $1,404,000

Under the three-ratio MSPM, Company C computes the post-production absorption ratio and allocable post-production additional section 263A costs as follows:

$$\frac{\text{Post-Production Additional Section 263A Costs Incurred During the Year}}{\text{Total Section 471 Costs Incurred During the Year – Unprocessed Raw Materials on Hand at Year End – WIP on Hand at Year End + Finished Goods on Hand at the Beginning of the Year}} = \text{Post-Production Absorption Ratio}$$

$$\frac{\$4,064,000}{\$127,000,000*} = .032$$

* $98,000,000 – $11,000,000 – $10,000,000 + $50,000,000 = $127,000,000

Post-Production Absorption Ratio	x	Finished Goods Section 471 Costs Incurred During the Year and Remaining on Hand at Year End*	=	Allocable Post-Production Additional Section 263A Costs

* Includes finished goods produced by Company C, property produced under contract for Company C, and property purchased for resale by Company C.

.032 x $26,600,000 = $851,200

Company C computes the total allocable additional section 263A costs under the three-ratio MSPM as follows:

Allocable Preproduction Additional Section 263A Costs	$643,200
Allocable Production Additional Section 263A Costs	$1,404,000
Allocable Post-Production Additional Section 263A Costs	$851,200
Total Allocable Additional Section 263A Costs	$2,898,400

VII. Allow Any Reasonable Method to Allocate Capitalizable Mixed Service Costs

Prop. Reg. § 1.263A-2(c)(3)(i)(E) provides that a taxpayer must apportion capitalizable mixed service costs between preproduction additional section 263A costs and production additional section 263A costs under the proposed MSPM.[10] Under the proposed regulations, the taxpayer must allocate capitalizable mixed service costs to preproduction additional section 263A costs in proportion to the raw material costs in total section 471 costs (i.e., direct material costs). The taxpayer must include the remaining capitalizable mixed service costs in production additional section 263A costs.

This proposed allocation of capitalizable mixed service costs is distortive because the allocation base provided by the proposed regulations does not bear any relation to the capitalizable mixed service costs being allocated. Most capitalizable mixed service costs are related to labor costs and indirect costs incurred in connection with capitalizable activities (i.e., preproduction, production, and post-production activities), not direct material costs. As such, using direct material costs to allocate capitalizable mixed service costs to preproduction additional section 263A costs will result in a disproportionate amount of mixed service costs allocated to preproduction additional section 263A costs, and to raw material costs in ending inventory ultimately.

Thus, the final regulations should provide that taxpayers using the MSPM (or the three-ratio MSPM) may use any reasonable method to allocate capitalizable mixed service costs between preproduction additional section 263A costs and production additional section 263A costs (and, under the three-ratio MSPM, post-production additional section 263A costs).

[10] Under the AICPA's proposed three-ratio MSPM, a taxpayer must apportion capitalizable mixed service costs between preproduction additional section 263A costs, production additional section 263A costs, and post-production additional section 263A costs.

Additionally, the final regulations should include the following methods as examples of reasonable methods for allocating capitalizable mixed service costs.

Capitalizable Costs Allocation Method

The final regulations should permit a taxpayer to allocate capitalizable mixed service costs between preproduction additional section 263A costs and production additional section 263A costs (and, under the three-ratio MSPM, post-production additional section 263A costs) based on the total capitalizable costs related to the underlying capitalizable activities ("the capitalizable costs allocation method"). Under this method, the taxpayer would exclude raw material section 471 costs from total capitalizable costs. The taxpayer's capitalizable mixed service costs allocable to preproduction additional section 263A costs would equal capitalizable mixed service costs multiplied by the ratio of capitalizable preproduction costs divided by total capitalizable costs. The taxpayer's capitalizable mixed service costs allocable to production additional section 263A costs would equal capitalizable mixed service costs multiplied by the ratio of capitalizable production costs divided by total capitalizable costs. Under the three-ratio MSPM, the taxpayer's capitalizable mixed service costs allocable to post-production additional section 263A costs would equal capitalizable mixed service costs multiplied by the ratio of capitalizable post-production costs divided by total capitalizable costs.

Under the capitalizable costs allocation method, capitalizable costs in the numerator of each ratio would equal section 471 costs related to the capitalizable activity (preproduction, production, or post-production), excluding raw material section 471 costs, plus additional section 263A costs related to the capitalizable activity (preproduction, production, or post-production), excluding capitalizable mixed service costs. Total capitalizable costs in the denominator of each ratio would equal total section 471 costs related to all capitalizable activities (preproduction, production, and post-production), excluding raw material section 471 costs, plus total additional section 263A costs related to all capitalizable activities (preproduction, production, and post-production), excluding capitalizable mixed service costs. The numerator and denominator of each ratio would exclude raw material section 471 costs to avoid the distortions discussed above.

Example 4 – The capitalizable costs allocation method for allocating capitalizable mixed service costs between preproduction additional section 263A costs, production additional section 263A costs, and post-production additional section 263A costs under the three-ratio MSPM.

Company D uses the three-ratio MSPM to allocate additional section 263A costs to ending inventory. Company D elects to use the capitalizable costs allocation method as a reasonable method for allocating capitalizable mixed service costs between preproduction additional section 263A costs, production additional section 263A costs, and post-production additional section 263A costs. Company D incurred $200,000 of capitalizable mixed service costs. Company D incurred $12,000,000 of capitalizable costs (section 471 costs plus additional section 263A costs), including $4,000,000 of raw material section 471 costs. For purposes of the capitalizable costs allocation method, Company D's total capitalizable costs are equal to $8,000,000 ($12,000,000 of capitalizable costs less $4,000,000 of raw material section 471

costs). These capitalizable costs include $160,000 related to preproduction activities, $7,360,000 related to production activities, and $480,000 related to post-production activities.

Under the capitalizable costs allocation method, Company D allocates capitalizable mixed service costs to preproduction additional section 263A costs as follows:

$$\text{Capitalizable Mixed Service Costs} \times \frac{\text{Total Capitalizable Costs Related to Preproduction Activities*}}{\text{Total Capitalizable Costs Related to All Capitalizable Activities*}} = \text{Amount Allocable to Preproduction Additional Section 263A Costs}$$

* Excluding raw material section 471 costs.

$$\$200{,}000 \times \frac{\$160{,}000}{\$8{,}000{,}000} = \$4{,}000$$

Under the capitalizable costs allocation method, Company D allocates capitalizable mixed service costs to production additional section 263A costs as follows:

$$\text{Capitalizable Mixed Service Costs} \times \frac{\text{Total Capitalizable Costs Related to Production Activities*}}{\text{Total Capitalizable Costs Related to All Capitalizable Activities*}} = \text{Amount Allocable to Production Additional Section 263A Costs}$$

* Excluding raw material section 471 costs.

$$\$200{,}000 \times \frac{\$7{,}360{,}000}{\$8{,}000{,}000} = \$184{,}000$$

Under the capitalizable costs allocation method, Company D allocates capitalizable mixed service costs to post-production additional section 263A costs as follows:

$$\text{Capitalizable Mixed Service Costs} \times \frac{\text{Total Capitalizable Costs Related to Post-Production Activities*}}{\text{Total Capitalizable Costs Related to All Capitalizable Activities*}} = \text{Amount Allocable to Post-Production Additional Section 263A Costs}$$

* Excluding raw material section 471 costs.

$$\$200{,}000 \times \frac{\$480{,}000}{\$8{,}000{,}000} = \$12{,}000$$

Capitalizable Labor Costs Allocation Method

Alternatively, the final regulations should permit a taxpayer to allocate capitalizable mixed service costs between preproduction additional section 263A costs and production additional section 263A costs (and, under the three-ratio MSPM, post-production additional section 263A costs) based on the capitalizable labor costs related to the underlying capitalizable activities

("the capitalizable labor costs allocation method"). Under this method, the taxpayer's capitalizable mixed service costs allocable to preproduction additional section 263A costs would equal capitalizable mixed service costs multiplied by the ratio of capitalizable preproduction labor costs divided by total capitalizable labor costs. The taxpayer's capitalizable mixed service costs allocable to production additional section 263A costs would equal capitalizable mixed service costs multiplied by the ratio of capitalizable production labor costs divided by total capitalizable labor costs. Under the three-ratio MSPM, the taxpayer's capitalizable mixed service costs allocable to post-production additional section 263A costs would equal capitalizable mixed service costs multiplied by the ratio of capitalizable post-production labor costs divided by total capitalizable labor costs.

Under the capitalizable labor costs allocation method, capitalizable labor costs in the numerator of each ratio would equal section 471 labor costs related to the capitalizable activity (preproduction, production, or post-production) plus additional section 263A labor costs related to the capitalizable activity (preproduction, production, or post-production), excluding capitalizable mixed service labor costs. Total capitalizable labor costs in the denominator of each ratio would equal total section 471 labor costs related to all capitalizable activities (preproduction, production, and post-production) plus total additional section 263A labor costs related to all capitalizable activities (preproduction, production, and post-production), excluding capitalizable mixed service labor costs.

Example 5 – The capitalizable labor costs allocation method for allocating capitalizable mixed service costs between preproduction additional section 263A costs, production additional section 263A costs, and post-production additional section 263A costs under the three-ratio MSPM.

Same facts as *Example 4*, except Company D elects to use the capitalizable labor costs allocation method as a reasonable method for allocating capitalizable mixed service costs between preproduction additional section 263A costs, production additional section 263A costs, and post-production additional section 263A costs. Company D's total capitalizable labor costs are $3,500,000, with $56,000 related to preproduction activities, $3,325,000 related to production activities, and $119,000 related to post-production activities.

Under the capitalizable labor costs allocation method, Company D allocates capitalizable mixed service costs to preproduction additional section 263A costs as follows:

$$\text{Capitalizable Mixed Service Costs} \times \frac{\text{Capitalizable Labor Costs Related to Preproduction Activities}}{\text{Capitalizable Labor Costs Related to All Capitalizable Activities}} = \text{Amount Allocable to Preproduction Additional Section 263A Costs}$$

$$\$200{,}000 \times \frac{\$56{,}000}{\$3{,}500{,}000} = \$3{,}200$$

Under the capitalizable labor costs allocation method, Company D allocates capitalizable mixed service costs to production additional section 263A costs as follows:

$$\text{Capitalizable Mixed Service Costs} \times \frac{\text{Capitalizable Labor Costs Related to Production Activities}}{\text{Capitalizable Labor Costs Related to All Capitalizable Activities}} = \text{Amount Allocable to Production Additional Section 263A Costs}$$

$$\$200{,}000 \times \frac{\$3{,}325{,}000}{\$3{,}500{,}000} = \$190{,}000$$

Under the capitalizable labor costs allocation method, Company D allocates capitalizable mixed service costs to post-production additional section 263A costs as follows:

$$\text{Capitalizable Mixed Service Costs} \times \frac{\text{Capitalizable Labor Costs Related to Post-Production Activities}}{\text{Capitalizable Labor Costs Related to All Capitalizable Activities}} = \text{Amount Allocable to Post-Production Additional Section 263A Costs}$$

$$\$200{,}000 \times \frac{\$119{,}000}{\$3{,}500{,}000} = \$6{,}800$$

We believe the methods describe above are reasonable methods because capitalizable costs (excluding raw material section 471 costs) and capitalizable labor costs are factually more closely related to the capitalizable mixed service costs being allocated. Moreover, these methods are similar to the method provided in Treas. Reg. § 1.263A-3(d)(i)(F), which requires a taxpayer using the simplified service cost method in conjunction with the SRM to allocate its mixed service costs to storage and handling activities and purchasing activities based on the labor costs allocable to the activities. In addition to the methods described above, the final regulations should permit taxpayers to use any other reasonable method to allocate capitalizable mixed service costs between preproduction additional section 263A costs and production additional section 263A costs (and, under the three-ratio MSPM, post-production additional section 263A costs).

VIII. MSPM for LIFO Inventory

The proposed regulations provide special rules for a taxpayer using the proposed MSPM and the LIFO inventory method. If the taxpayer has a LIFO inventory increment for the year, the taxpayer must multiply the LIFO inventory increment by the "combined absorption ratio." The combined absorption ratio is defined as the quotient of the total additional section 263A costs allocable to "eligible property remaining on hand at year end" divided by the "section 471 costs remaining on hand at year end," as defined in Treas. Reg. § 1.263A-2(b)(3)(ii)(B).

Under the proposed regulations, "eligible property remaining on hand at year end" is not specifically defined, but it is equal to "raw material section 471 costs incurred during the taxable year and remaining on hand at year end" plus "production section 471 costs incurred during the taxable year and remaining on hand at year end." The example in the proposed regulations disregards the LIFO inventory method when determining "raw material section 471 costs incurred during the taxable year and remaining on hand at year end" and "production section 471 costs incurred during the taxable year and remaining on hand at year end."

However, the language in the proposed regulations is ambiguous. Consequently, taxpayers or IRS examiners could misinterpret the rules and conclude that these amounts are determined on a LIFO basis, resulting in a distorted combined absorption ratio.

Furthermore, as noted above, for purposes of applying the proposed MSPM to LIFO inventory, the denominator of the combined absorption ratio is the "section 471 costs remaining on hand at year end," as defined in Treas. Reg. § 1.263A-2(b)(3)(ii)(B). Treas. Reg. § 1.263A-2(b)(3)(ii)(B) provides that, for LIFO inventories of a taxpayer, the "section 471 costs remaining on hand at year end" is the increment, if any, for the current year, stated in terms of section 471 costs (i.e., the LIFO value of the increment). Using this definition of "section 471 costs remaining on hand at year end," the combined absorption ratio would equal the additional section 263A costs allocable to eligible property remaining on hand at year end divided by the LIFO value of the increment. If the resulting ratio is multiplied by the LIFO value of the increment, as currently required under the proposed regulations, the entire amount of additional section 263A costs allocable to eligible property remaining on hand at year end (on a non-LIFO basis) is capitalized to the LIFO increment. In other words, the amount of additional section 263A costs capitalized to the LIFO increment would equal the amount of additional section 263A costs capitalized to ending inventory under a non-LIFO method. Clearly, this result was not intended. We note that, in the example provided in the proposed regulations, the section 471 costs remaining on hand at year end in the denominator of the combined absorption ratio is equal to the current cost (e.g., FIFO value) of ending inventory, rather than the LIFO value of the increment. We believe the IRS and Treasury intended to define the "section 471 costs remaining on hand at year end" consistent with the example in the proposed regulations.

To address the issues described above, the final regulations should define "eligible property remaining on hand at year end" as the non-LIFO basis of section 471 costs incurred during the taxable year and remaining on hand at year end (i.e., the current cost of ending inventory). As a result, the "total additional section 263A costs allocable to eligible property remaining on hand at year end" (the numerator of the combined absorption ratio) would equal the total additional section 263A costs allocable to the current cost (e.g., FIFO value) of ending inventory. Furthermore, the final regulations should remove the cross reference to Treas. Reg. § 1.263A-2(b)(3)(ii)(B) and clarify that the "section 471 costs remaining on hand at year end" in the denominator of the combined absorption ratio is equal to the current cost (e.g., FIFO value) of ending inventory.

When combined with our suggested changes above, we believe the proposed method for calculating the additional section 263A costs that are added to the taxpayer's LIFO inventory increment for the year is appropriate. We note that, if the MSPM is revised to add the post-production absorption ratio, as proposed above, then the numerator of the combined absorption ratio would include the total preproduction additional section 263A costs, production additional section 263A costs, and post-production additional section 263A costs allocable to eligible property remaining on hand at year end.

In addition, the final regulations should provide a special rule for taxpayers using the raw material content LIFO method. Under the raw material content LIFO method, the LIFO inventory method is applied to unprocessed raw materials and the raw material content of WIP and finished goods, but it is not applied to labor and overhead costs. Therefore, if a taxpayer

uses the proposed MSPM (or the three-ratio MSPM) in conjunction with the raw material content LIFO method, and the taxpayer has a LIFO increment for the year, then the taxpayer will need to multiply the LIFO value of the increment by a combined absorption ratio.

Under the three-ratio MSPM, the numerator of this combined absorption ratio would equal the preproduction additional section 263A costs allocable to raw material section 471 costs incurred during the taxable year and remaining on hand at year end plus the post-production additional section 263A costs allocable to the raw material section 471 costs incurred during the taxable year and remaining in finished goods on hand at year end. For this purpose, the post-production additional section 263A costs allocable to the raw material section 471 costs incurred during the taxable year and remaining in finished goods on hand at year end would equal the post-production absorption ratio multiplied by the raw material section 471 costs incurred during the taxable year and remaining in finished goods on hand at year end (i.e., the raw material content of finished goods in ending inventory). The denominator of the combined absorption ratio would equal total raw material section 471 costs incurred during the taxable year and remaining on hand at year end (i.e., unprocessed raw materials plus the raw material content of WIP and finished goods).

Additional section 263A costs allocable to production section 471 costs (i.e., section 471 labor and overhead costs) incurred during the taxable year and remaining on hand at year end would equal the production absorption ratio multiplied by production section 471 costs incurred during the taxable year and remaining on hand at year end (i.e., labor and overhead costs in ending inventory) plus the post-production absorption ratio multiplied by production section 471 costs incurred during the taxable year and remaining in finished goods on hand at year end (i.e., the labor and overhead content of finished goods in ending inventory).

Example 6 – Three-Ratio MSPM Used with the Raw Material Content LIFO Method.

Company E uses the raw material content LIFO method. Under this method, Company E uses one raw material content pool, and this pool has an increment with a LIFO value of $400,000. Company E uses the three-ratio MSPM to allocate additional section 263A costs to ending inventory. Under the three-ratio MSPM, Company E's preproduction absorption ratio is .01, its production absorption ratio is .075, and its post-production absorption ratio is .038.

Company E determines that the following section 471 costs incurred during the year remain in its ending inventory:

	Total	Raw Material Costs	Labor and Overhead Costs
Ending Inventory – Unprocessed Raw Materials	$6,000,000	$6,000,000	
Ending Inventory – WIP	$7,200,000	$4,000,000	$3,200,000
Ending Inventory – Finished Goods	$22,800,000	$10,000,000	$12,800,000
Total Section 471 Costs in Ending Inventory	$36,000,000	$20,000,000	$16,000,000

Under the three-ratio MSPM, Company E computes the preproduction additional section 263A costs allocable to raw material section 471 costs incurred during the year and remaining on hand at year end as follows:

Preproduction Absorption Ratio	x	Raw Material Section 471 Costs Incurred During the Year and Remaining on Hand at Year End	=	Allocable Preproduction Additional Section 263A Costs

.01 x $20,000,000 = $200,000

Under the three-ratio MSPM, Company E computes the post-production additional section 263A costs allocable to the raw material content of finished goods in ending inventory as follows:

Post-Production Absorption Ratio	x	Raw Material Content of Finished Goods in Ending Inventory	=	Post-Production Additional Section 263A Costs Allocable to the Raw Material Content of Finished Goods in Ending Inventory

.038 x $10,000,000 = $380,000

Under the three-ratio MSPM, Company E computes the additional section 263A costs allocable to the LIFO increment as follows:

$$\frac{\text{Allocable Preproduction Additional Section 263A Costs + Post-Production Additional Section 263A Costs Allocable to the Raw Material Content of Finished Goods in Ending Inventory}}{\text{Total Raw Material Section 471 Costs Incurred During the Year and Remaining on Hand at Year End}} = \text{Combined Absorption Ratio}$$

$$\frac{\$580,000^*}{\$20,000,000} = .029$$

* $200,000 + $380,000 = $580,000

Combined Absorption Ratio	x	LIFO Value of Increment	=	Additional Section 263A Costs Allocable to the LIFO Increment

.029 x $400,000 = $11,600

Under the three-ratio MSPM, Company E computes the additional section 263A costs allocable to production section 471 costs incurred during the taxable year and remaining on hand at year end (i.e., section 471 labor and overhead costs in ending inventory) as follows:

Production Absorption Ratio	x	Section 471 Labor and Overhead Costs in Ending Inventory	=	Allocable Production Additional Section 263A Costs

.075 x $16,000,000 = $1,200,000

Post-Production Absorption Ratio	x	Labor and Overhead Content of Finished Goods	=	Post-Production Additional Section 263A Costs Allocable to the Labor and Overhead Content of Finished Goods in Ending Inventory

.038 x $12,800,000 = $486,400

Allocable Production Additional Section 263A Costs	+	Post-Production Additional Section 263A Costs Allocable to the Labor and Overhead Content of Finished Goods in Ending Inventory	=	Additional Section 263A Costs Allocable to Section 471 Labor and Overhead Costs in Ending Inventory

$1,200,000 + $486,400 = $1,686,400

IX. Extension of the Qualifying Period Under the MSPM with a HAR Election

The proposed regulations allow taxpayers to use the MSPM with a HAR election. In general, a taxpayer using the MSPM with a HAR election must calculate a preproduction HAR and a production HAR based on costs capitalized by the taxpayer during the test period.[11] A taxpayer using the MSPM with a HAR election that also uses the LIFO inventory method must calculate a combined HAR based on costs capitalized by the taxpayer during the test period. The taxpayer must use the preproduction and production HARs or, for LIFO inventory, the combined HAR, instead of actual ratios during the qualifying period. The proposed regulations also provide rules for determining whether the qualifying period is extended under the MSPM with a HAR election. We recommend some modifications to these rules as described below.

Under the proposed regulations, for the taxable year immediately following the qualifying period (the recomputation year), a taxpayer using a non-LIFO (e.g., FIFO, rolling average) inventory method computes actual preproduction and production absorption ratios under the proposed MSPM. If both the actual preproduction and actual production absorption ratios for the recomputation year are within one-half of one percentage point (plus or minus) of the corresponding HARs, then the qualifying period is extended to include the recomputation year and the following five taxable years (the extended qualifying period). The taxpayer must then continue to use the preproduction and production HARs during the extended qualifying period.

[11] Under the AICPA's proposed three-ratio MSPM, a taxpayer would also calculate a post-production HAR.

However, if either the actual preproduction absorption ratio or the actual production absorption ratio is not within one-half of one percentage point (plus or minus) of the corresponding HAR, then the taxpayer must use the actual preproduction and actual production absorption ratios for the recomputation year and the following two taxable years (the updated test period). The taxpayer then must calculate new preproduction and production HARs based on the updated test period and begins using the new HARs in the third taxable year following the recomputation year (i.e., the first taxable year following the updated test period).

Under the proposed regulations, the rules for LIFO inventory are similar to the rules described above. However, for LIFO inventory, a taxpayer must compute an actual combined absorption ratio for the recomputation year. If this ratio is within one-half of one percentage point (plus or minus) of the combined HAR, then the qualifying period is extended. If the actual combined absorption ratio is not within one-half of one percentage point (plus or minus) of the combined HAR, then the taxpayer must use the actual combined absorption ratio for each year of the updated test period. The taxpayer then must calculate a new combined HAR based on the updated test period and begin using the new combined HAR in the first taxable year following the updated test period.

We believe the rules for determining whether the qualifying period is extended for LIFO inventory should apply to all inventory.[12] Therefore, for the recomputation year, a taxpayer using the three-ratio MSPM would use the preproduction, production, and post-production HARs to determine the total HAR amount of additional section 263A costs allocable to eligible property remaining on hand at year end. Then, the taxpayer would compute a combined HAR equal to the total HAR amount of additional section 263A costs allocable to eligible property remaining on hand at year end divided by the section 471 costs remaining on hand at year end.

In addition, the taxpayer would compute an actual combined absorption ratio for the recomputation year equal to the total actual amount of preproduction, production, and post-production additional section 263A costs allocable to eligible property remaining on hand at year end divided by the section 471 costs remaining on hand at year end. If this ratio is within one-half of one percentage point (plus or minus) of the combined HAR, then the qualifying period is extended, and the taxpayer would continue to use the previous preproduction, production, and post-production HARs during the extended qualifying period. If the actual combined absorption ratio is not within one-half of one percentage point (plus or minus) of the combined HAR, then the taxpayer would use actual preproduction, production, and post-production absorption ratios for each year of the updated test period. The taxpayer then would calculate new preproduction, production, and post-production HARs based on the updated test period and begin using the new HARs in the first year following the updated test period.

Example 7 – Extension of Qualifying Period under the Three-Ratio MSPM with a HAR Election.

Company F uses the three-ratio MSPM with a HAR election to allocate additional section 263A costs to ending inventory. Under this method, Company F's preproduction HAR is .0082, its production HAR is .0338, and its post-production HAR is .0299.

[12] The following discussion of these rules is based on the AICPA's proposed three-ratio MSPM.

For the recomputation year, Company F computes an actual preproduction ratio of .015, an actual production ratio .019, and an actual post-production ratio of .03.

Company F determines that the following section 471 costs incurred during the year remain in its ending inventory:

	Total	Raw Material Costs	Labor and Overhead Costs
Ending Inventory – Unprocessed Raw Materials	$8,000,000	$8,000,000	
Ending Inventory – WIP	$4,000,000	$1,000,000	$3,000,000
Ending Inventory – Finished Goods	$20,000,000	$6,000,000	$14,000,000
Total Section 471 Costs in Ending Inventory	$32,000,000	$15,000,000	$17,000,000

Company F uses the actual preproduction, production, and post-production absorption ratios to compute the actual allocable preproduction additional section 263A costs, the actual allocable production additional section 263A costs, and the actual allocable post-production additional section 263A costs as follows:

Actual Preproduction Absorption Ratio	x	Raw Material Section 471 Costs Incurred During the Year and Remaining on Hand at Year End	=	Actual Allocable Preproduction Additional Section 263A Costs

.015 x $15,000,000 = $225,000

Actual Production Absorption Ratio	x	Production Section 471 Costs Incurred During the Year and Remaining on Hand at Year End	=	Actual Allocable Production Additional Section 263A Costs

.019 x $17,000,000 = $323,000

Actual Post-Production Absorption Ratio	x	Section 471 Costs Incurred During the Year and Remaining in Finished Goods on Hand at Year End	=	Actual Allocable Post-Production Additional Section 263A Costs

.03 x $20,00,000 = $600,000

Actual Allocable Preproduction Additional Section 263A Costs	$225,000
Actual Allocable Production Additional Section 263A Costs	$323,000
Actual Allocable Post-Production Additional Section 263A Costs	$600,000
Total Actual Allocable Additional Section 263A Costs	$1,148,000

In addition, Company F uses the preproduction, production, and post-production HARs to compute the HAR allocable preproduction additional section 263A costs, the HAR allocable production additional section 263A costs, and the HAR allocable post-production additional section 263A costs as follows:

Preproduction HAR	x	Raw Material Section 471 Costs Incurred During the Year and Remaining on Hand at Year End	=	HAR Allocable Preproduction Additional Section 263A Costs

.0082 x $15,000,000 = $123,000

Production HAR	x	Production Section 471 Costs Incurred During the Year and Remaining on Hand at Year End	=	HAR Allocable Production Additional Section 263A Costs

.0338 x $17,000,000 = $574,600

Post-Production HAR	x	Section 471 Costs Incurred During the Year and Remaining in Finished Goods on Hand at Year End	=	HAR Allocable Post-Production Additional Section 263A Costs

.0299 x $20,00,000 = $598,000

HAR Allocable Preproduction Additional Section 263A Costs	$123,000
HAR Allocable Production Additional Section 263A Costs	$574,600
HAR Allocable Post-Production Additional Section 263A Costs	$598,000
Total HAR Allocable Additional Section 263A Costs	$1,295,600

Company F computes the actual combined absorption ratio and the combined HAR and then compares the actual combined absorption ratio to the combined HAR as follows:

Total Actual Allocable Additional Section 263A Costs / Total Section 471 Costs Incurred During the Year and Remaining on Hand at Year End	$1,148,000 / $32,000,000	=	.0359
Total HAR Allocable Additional Section 263A Costs / Total Section 471 Costs Incurred During the Year and Remaining on Hand at Year End	$1,295,600 / $32,000,000	=	.0405
Difference			(.0046)

Because the actual combined absorption ratio is within one-half of one percentage point (plus or minus) of the combined HAR, Company F will continue to use the previous preproduction, production, and post-production HARs for a new extended qualifying period.

X. HAR Transition Rules

The AICPA recommends the following transition rules for taxpayers using the SPM with a HAR election that change to the MSPM with a HAR election. These proposed transition rules are based on a change to the three-ratio MSPM but could also apply to the proposed MSPM.

Under the AICPA's proposed transition rules, a taxpayer using the SPM with a HAR election that changes to the three-ratio MSPM would continue to use the HAR election, but with a new test period. For a taxpayer using the LIFO inventory method, the new test period would include the three taxable years immediately preceding the year of change. A taxpayer using a non-LIFO (e.g., FIFO, rolling average) inventory method could elect to use a new test period that includes the three taxable years immediately preceding the year of change.[13] Otherwise, a taxpayer using a non-LIFO inventory method would use a new test period that includes the taxable year immediately preceding the year of change, the year of change, and the taxable year immediately following the year of change. A taxpayer changing from the SPM with a HAR election to the three-ratio MSPM with a HAR election would compute actual preproduction, production, and post-production absorption ratios (or, for LIFO inventory, an actual combined absorption ratio) for each year of the applicable new test period.

Furthermore, the transition rules should require a section 481(a) adjustment for a taxpayer changing from the SPM with a HAR election to the three-ratio MSPM with a HAR election. This adjustment should replicate the section 481(a) adjustment for a taxpayer changing from the SPM (without a HAR election) to the three-ratio MSPM (without a HAR election). Accordingly, for non-LIFO inventory, the taxpayer would multiply the actual preproduction, production, and post-production absorption ratios *for the taxable year immediately preceding the year of change*[14] by the applicable section 471 costs remaining in inventory as of the beginning of the year of change to determine the additional section 263A costs allocable to beginning inventory under the three-ratio MSPM. The section 481(a) adjustment would equal the recomputed additional section 263A costs allocable to the taxpayer's beginning inventory (under the three-ratio MSPM) minus the additional section 263A costs that were capitalized to the taxpayer's beginning inventory (under the SPM with a HAR election). For LIFO inventory, the taxpayer would compute the section 481(a) adjustment resulting from the change in accounting method in a similar manner, but using the methods described in Treas. Reg. § 1.263A-7 (e.g., facts-and-circumstances revaluation method; three-year average method).

To determine the additional section 263A costs capitalized to non-LIFO inventory during the qualifying period under the three-ratio MSPM with a HAR election, the taxpayer would use the actual absorption ratios for the new test period to compute preproduction, production, and post-

[13] The election to use a new test period that includes the three taxable years immediately preceding the year of change would allow taxpayers that have both non-LIFO and LIFO inventory to use the same test period. In addition, a taxpayer in its first year of a qualifying period under the SPM with a HAR election would have just completed a test period that includes the three taxable years immediately preceding the year of change and may prefer to use this period as the new test period under the three-ratio MSPM with a HAR election.

[14] The taxable year immediately preceding the year of change is either the third taxable year or the first taxable year of the new test period, depending on the test period elected by the taxpayer.

production HARs and would use these HARs during the qualifying period.[15] To determine the additional section 263A costs capitalized to LIFO inventory during the qualifying period under the three-ratio MSPM with a HAR election, the taxpayer would use the actual combined absorption ratios for the new test period to compute a combined HAR and would use the combined HAR during the qualifying period.

Example 8 – Change to the Three-Ratio MSPM with a HAR Election.

Company G uses the FIFO inventory method and uses the SPM with a HAR election to allocate additional section 263A costs to ending inventory. Company G's SPM HAR from its most recent test period is .05.

Company G changes to the three-ratio MSPM with a HAR election and elects to use a test period that includes the three taxable years immediately preceding the year of change. Company G implements the change by computing actual preproduction, production, and post-production HARs for the test period, as follows, where Year 1 is the third taxable year immediately preceding the year of change, Year 2 is the second taxable year immediately preceding the year of change, and Year 3 is the taxable year immediately preceding the year of change:

Test Period	Preproduction Additional Section 263A Costs Incurred During the Year	Raw Material Section 471 Costs Incurred During the Year	Actual Preproduction Absorption Ratio
Year 1	$85,000	$5,000,000	.0170
Year 2	$82,000	$5,000,000	.0164
Year 3	$91,720	$5,400,000	.0170
	$258,720	$15,400,000	

Test Period	Production Additional Section 263A Costs Incurred During the Year	Production Section 471 Costs Incurred During the Year	Actual Production Absorption Ratio
Year 1	$350,000	$14,000,000	.0250
Year 2	$408,000	$15,000,000	.0272
Year 3	$490,800	$15,600,000	.0315
	$1,248,800	$44,600,000	

[15] For a taxpayer that elects to use a new test period that includes the three taxable years immediately preceding the year of change, the first year of the qualifying period is the year of change. For a taxpayer that elects to use a new test period that includes the taxable year immediately preceding the year of change, the year of change, and the taxable year immediately following the year of change, the first year of the qualifying period is the second taxable year following the year of change (i.e., the first taxable year following the new test period).

Test Period	Post-Production Additional Section 263A Costs Incurred During the Year	Total Section 471 Costs Incurred During the Year – Unprocessed Raw Materials on Hand at Year End – WIP on Hand at Year End + Finished Goods on Hand at the Beginning of the Year	Actual Post-Production Absorption Ratio
Year 1	$420,000	$25,800,000	.0163
Year 2	$510,000	$27,670,000	.0184
Year 3	$562,480	$28,810,000	.0195
	$1,492,480	$82,280,000	

Company G determines that the following section 471 costs remained in inventory as of the beginning of the year of change (i.e., Year 3):

	Total	Raw Material Costs	Labor and Overhead Costs
Ending Inventory – Unprocessed Raw Materials	$500,000	$500,000	
Ending Inventory – WIP	$1,000,000	$800,000	$200,000
Ending Inventory – Finished Goods	$10,500,000	$2,900,000	$7,600,000
Total Section 471 Costs in Ending Inventory	$12,000,000	$4,200,000	$7,800,000

Company G computes the section 481(a) adjustment resulting from the change to the three-ratio MSPM with a HAR election as follows:

Preproduction Absorption Ratio – Year 3 x Raw Material Section 471 Costs Remaining in Inventory as of the Beginning of the Year of Change = Allocable Preproduction Additional Section 263A Costs

.0170 x $4,200,000 = $71,400

Production Absorption Ratio – Year 3 x Production Section 471 Costs Remaining in Inventory as of the Beginning of the Year of Change = Allocable Production Additional Section 263A Costs

.0315 x $7,800,000 = $245,700

Post-Production Absorption Ratio – Year 3 x Finished Goods Section 471 Costs Remaining in Inventory as of the Beginning of the Year of Change = Allocable Post-Production Additional Section 263A Costs

.0195 x $10,500,000 = $204,750

Allocable Preproduction Additional Section 263A Costs	$71,400
Allocable Production Additional Section 263A Costs	$245,700
Allocable Post-Production Additional Section 263A Costs	$204,750
Total Additional Section 263A Costs Capitalized to Beginning Inventory under the Three-Ratio MSPM HAR	$521,850
Less: Total Additional Section 263A Costs Capitalized to Beginning Inventory under the SPM HAR	$600,000*
Section 481(a) Adjustment (Decrease to Taxable Income)	($78,150)

* .05 x $12,000,000 = $600,000

Company G computes the preproduction, production, and post-production HARs as follows:

$$\frac{\text{Total Preproduction Additional Section 263A Costs Incurred During the Test Period}}{\text{Total Raw Material Section 471 Costs Incurred During the Test Period}} = \text{Preproduction HAR}$$

$$\frac{\$258,720}{\$15,400,000} = .0168$$

$$\frac{\text{Total Production Additional Section 263A Costs Incurred During the Test Period}}{\text{Total Production Section 471 Costs Incurred During the Test Period}} = \text{Production HAR}$$

$$\frac{\$1,248,800}{\$44,600,000} = .0280$$

$$\frac{\text{Total Post-Production Additional Section 263A Costs Incurred During the Test Period}}{\text{Total Post-Production Section 471 Costs Incurred During the Test Period}} = \text{Post-Production HAR}$$

$$\frac{\$1,492,480}{\$82,280,000} = .0181$$

Company G would use these preproduction, production, and post-production HARs for the qualifying period that includes the year of change and the next four tax years.

XI. Definition of Section 471 Costs

A. Treatment of Direct Costs

Proposed Reg. § 1.263A-1(d)(2)(i) provides that, for purposes of section 263A, section 471 costs are the costs, other than interest, that a taxpayer capitalizes to its inventory (or other eligible property) in its financial statements, except to the extent the taxpayer is required or permitted to reduce section 471 costs for negative amounts. The AICPA generally agrees with the proposed definition of section 471 costs. This definition is consistent with the definition of section 471 costs that is used widely in practice by most taxpayers. However, the proposed regulations further provide that, notwithstanding the last sentence of Treas. Reg. § 1.263A-1(g)(2), section 471 costs must include all direct costs of producing property and of acquiring property for resale, whether or not a taxpayer capitalizes these costs to inventory or other eligible property in its financial statements.

We are concerned that this exception to the general definition of section 471 costs requires taxpayers to clearly distinguish between direct and indirect costs. Taxpayers might find such distinction difficult to make because they are not required to distinguish between direct and indirect costs under the current regulations. For example, Treas. Reg. § 1.263A-1(g)(2) allows taxpayers to allocate direct labor costs as indirect costs. Therefore, some taxpayers treat elements of direct labor costs, such as holiday pay, vacation pay, sick pay, payroll taxes, or unemployment benefits, as indirect costs.

Furthermore, the proposed regulations limit the methods taxpayers may use to allocate direct costs by requiring taxpayers to treat such costs as section 471 costs. If a taxpayer is no longer permitted to treat direct costs as additional section 263A costs, then direct costs cannot be allocated using the taxpayer's method of allocating additional section 263A costs. By requiring the taxpayer to treat direct costs as section 471 costs, the taxpayer must allocate direct costs using its method of allocating section 471 costs. We note that this requirement is inconsistent with Treas. Reg. § 1.263A-1(f), which provides that, in lieu of using a facts-and-circumstances allocation method, taxpayers may use the simplified methods to allocate direct and indirect costs to eligible property.

In addition, many taxpayers that currently treat direct labor costs as indirect costs pursuant to Treas. Reg. § 1.263A-1(g)(2) are using simplified methods to allocate such costs. In order to carve out any direct labor costs currently treated as indirect costs and allocate such costs as section 471 costs, taxpayers must create a second inventory costing system for tax purposes only. We are concerned that the time and costs associated with implementing and maintaining a second inventory costing system will prevent taxpayers from complying with the proposed regulations. Instead of implementing a second inventory costing system, taxpayers would most likely attempt to estimate the adjustment to section 471 costs. In this circumstance, the adjustment to section 471 costs could become the subject of controversy between taxpayers and the IRS.

The proposed general definition of section 471 costs (i.e., costs capitalized to inventory or other eligible property in the taxpayer's financial statements) provides a bright line rule that taxpayers can easily apply. However, the requirement that section 471 costs also must include

all direct costs of producing property and of acquiring property for resale adds unnecessary complexity to the general definition of section 471 costs. Therefore, the final regulations should exclude this requirement.

B. Additional Complexity Related to Variances

The AICPA is particularly concerned that the requirement to treat all direct costs as section 471 costs under the proposed regulations creates additional complexity if variances are treated as direct costs. If variances related to direct costs (e.g., purchase price variances, direct labor variances) are treated as direct costs, then taxpayers would have to treat these variances as section 471 costs, even if the variances are not capitalized to inventory in the taxpayer's financial statements. As a result, taxpayers would have to adjust their section 471 costs incurred during the taxable year and their section 471 costs incurred during the taxable year and remaining on hand at year end to include variances related to direct costs. In order to satisfy this requirement, taxpayers would have to create and maintain a second inventory costing system for tax purposes only. As noted above, the time and costs associated with implementing a second inventory costing system could prevent taxpayers from complying with the proposed regulations. Instead of implementing a second inventory costing system, taxpayers would most likely attempt to estimate the adjustment to ending inventory using a "topside" approach. For example, a taxpayer might calculate variances allocable to ending inventory using an inventory turns method (i.e., total variances divided by inventory turns). In this circumstance, the amount of variances allocable to ending inventory could become the subject of controversy between taxpayers and the IRS because an inventory turns method is less precise than the methods used to allocate other section 471 costs (e.g., standard cost method, burden rate method).

Therefore, the final regulations should provide that only variances capitalized to ending inventory in a taxpayer's financial statements are treated as section 471 costs, and all other variances capitalized under section 263A are treated as additional section 263A costs.

C. Ending Inventory Value Subject to Section 263A

For inventory property, the final regulations should allow a taxpayer to adjust section 471 costs incurred during the taxable year and remaining on hand at year end (i.e., book ending inventory costs) to reflect the methods of accounting used by the taxpayer for federal income tax purposes.

For example, a retailer using the FIFO lower of cost or market ("LCM") method to value ending inventory for financial statement purposes might use the retail LCM method for tax purposes. In this circumstance, the retailer should adjust its section 471 costs incurred during the taxable year and remaining on hand at year end to account for the difference between the ending inventory value under FIFO LCM method and the retail LCM method. As a result, the taxpayer would use the retail LCM method to determine the ending inventory value subject to section 263A. The ending inventory value subject to section 263A should reflect similar adjustments to account for all differences between the financial statement methods and the tax methods used to determine the value of ending inventory (e.g., cash discounts, trade discounts, inventory shrinkage, subnormal goods, inventory reserves).

Therefore, the final regulations should clarify that, for inventory property, the taxpayer must adjust section 471 costs incurred during the taxable year and remaining on hand at year end (i.e., book ending inventory costs) to reflect the methods of accounting used for federal income tax purposes. As a result, the ending inventory value subject to section 263A would reflect the methods of accounting used by the taxpayer to value ending inventory for federal income tax purposes prior to applying the simplified method absorption ratio(s).[16]

XII. Conclusion

In conclusion, the AICPA recommends that the final section 263A regulations:

1. Allow taxpayers to include negative amounts in additional section 263A costs under the SPM and permit the MSPM (with the changes described above) as an elective alternative to the SPM;

2. Change the definition of small taxpayer if taxpayers are not permitted to include negative amounts in additional section 263A costs under the SPM;

3. Allow a taxpayer to estimate the raw material content of WIP and finished goods under the proposed MSPM (or the three-ratio MSPM);

4. Add the post-production ratio to the proposed MSPM;

5. Provide rules for property produced under contract for the taxpayer and property purchased for resale by the taxpayer under the proposed MSPM (or the three-ratio MSPM);

6. Allow taxpayers to use any reasonable method to allocate capitalizable mixed service costs under the proposed MSPM (or the three-ratio MSPM);

7. Correctly apply the proposed MSPM (or the three-ratio MSPM) to LIFO inventory;

8. Change the rules for determining whether or not the qualifying period is extended under the MSPM (or the three-ratio MSPM) with a HAR election;

9. Provide transition rules for taxpayers that change from the SPM with a HAR election to the MSPM (or the three-ratio MSPM) with a HAR election; and

10. Modify the proposed definition of section 471 costs.

[16] Generally, section 471 costs incurred during the taxable year should not include these adjustments because the adjustments relate solely to the value of ending inventory. However, section 471 costs incurred during the taxable year should include adjustments for trade discounts (and, if applicable, cash discounts) because discounts represent adjustments to the purchase price of goods acquired during the year.

The AICPA welcomes the opportunity to meet with you to discuss our comments and answer any questions you may have.