



TAX ALERT

To: All Tax Accounting Clients

**From: Les Schneider
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Date: August 11, 2023

Re: Computation of Cost of Goods Sold for Tax Purposes

A. New Development

1. The purpose of this alert is to point out that the LB&I Division of the Internal Revenue Service has just added a new campaign to the list of issues on which LB&I will focus in its audits of companies selling merchandise and maintaining inventories.
2. The campaign relates to taxpayers that have overstated cost of goods sold (“CGS”), thereby reducing taxable income.
3. The announcement of the new campaign does not provide any color on what issues LB&I is focused on.

B. What is Behind the Campaign?

1. In informal discussions with the IRS National Office, National Office personnel have indicated that they are aware that numerous taxpayers have made efforts to reclass section 162 and 163 expenses as CGS to obtain various benefits that are available when an expense is classified as CGS.

C. What are Those Benefits?

1. Section 162 and 163 expenses that are allocable to CGS avoid the special deduction sourcing and allocation rules under Treas. Reg. § 1.861-8.
2. Interest expense under section 163 allocable to the construction of fixed assets or to the production of inventory is exempt from the deduction limitations in section 163(j).
3. Payments to related parties that are treated as part of the payor’s CGS are not treated as base erosion payments for BEAT purposes.
4. Reclassifying particular section 162 and 163 expenses as CGS may affect a taxpayer’s computation of the amount of GILTI and FDII.

5. Allocating inventoriable costs to CGS instead of ending inventory reduces a taxpayer's taxable income.

D. What Ground Rules Apply in Determining the Composition of CGS?

1. In general, in order for a section 162 or 163 expense to be treated as part of CGS, that expense must be treated as an inventoriable cost under section 263A.
2. However, there is some flexibility in the section 263A rules for determining what expenses may or must be treated as inventoriable costs. For example, it might be possible to treat the amortized portion of section 174 costs as an inventoriable cost even though such treatment is not required. However, the IRS has not addressed that issue.
3. In addition, there is flexibility in the elections that are available under section 263A to enable taxpayers to increase the proportion of inventoriable costs that are deducted as CGS, rather than be allocated to ending inventory.

E. Does a Taxpayer Have Freedom to Change the Components of CGS?

1. If a change in the components of a taxpayer's CGS affects the timing of a deduction, then the change in treatment is a change in method of accounting that requires the IRS's advance consent. Such an accounting method change does not generally qualify for the automatic consent procedures.
2. However, if a change in the components of CGS effectuates a permanent change in a taxpayer's taxable income, that change may be made unilaterally by the taxpayer, without obtaining the consent of the IRS.

F. Tax Planning Opportunities

1. There are several opportunities to legitimately reclass section 162 and 163 expenses as CGS. One fairly common opportunity results from a common mistake that many taxpayers make, due to the fact that most taxpayers determine their inventoriable costs throughout the taxable year on a book basis.
 - a. To apply section 263A, the taxpayers then compute the aggregate amount of additional section 263A costs incurred throughout the year that they are required to treat as inventoriable costs for tax purposes (such costs normally cannot be included in inventory for book purposes under GAAP).
 - b. After computing the aggregate amount of additional section 263A costs incurred during the taxable year, taxpayers must compute one or more absorption ratios under either the simplified production method or the modified simplified production method.

- c. Taxpayers then multiply the absorption ratio or ratios by the aggregate amount of additional section 263A costs incurred throughout the year to determine the fraction of such costs that must be capitalized to ending inventory.
 - d. Taxpayers then make a year-end Schedule M adjustment for those additional section 263A costs that are capitalized to ending inventory solely for tax purposes.
 - e. What taxpayers often overlook, however, is that the balance of the additional section 263A costs that are not reclassified as CGS through a year-end Schedule M adjustment to ending inventory should also be reclassified as CGS, even though that reclass does not change the timing of the deduction of that expense.
 - f. Accordingly, in preparing a taxpayer's tax return, a manual reclass of particular section 162 expenses (for example, mixed service costs) that are included in inventoriable costs at year-end for tax purposes only is required in order to treat as part of CGS the portion of those same expenses that are not included in ending inventory. For example, if under the modified simplified production method, 8% of mixed service costs are allocated to ending inventory for tax purposes under section 263A, the 92% balance of those mixed service costs should also be reclassified from section 162 to CGS, notwithstanding that such reclass does not change the timing of the deductions.
2. Another planning opportunity would be for a taxpayer to make a section 266 election to capitalize interest and certain carrying costs in acquiring inventory that would not otherwise be treated as inventoriable costs for purposes of section 263A. For example, section 263A(f) requires interest capitalization in only a very narrow set of circumstances, whereas section 266 could apply more broadly.
3. Finally, there are various elections available under section 263A that would enable a taxpayer to enlarge the types of section 162 expenses that could be treated as inventoriable costs and therefore as part of CGS. While that might result in a brief temporary deferral of the deduction of the expense, the reclass effect on a taxpayer's CGS and gross income would be more impactful.

If any of these issues might apply to your company and you wish to discuss the issues with us, please email or call us.