Ivins Phillips Barker
CHARTERED

August 30, 2020

Commissioner of Internal Revenue
Internal Revenue Service
Attn: CC:PA:LPD:PR (REG- REG-132766-18)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Comments with Respect to REG-132766-18

Dear Sir:

On August 5, 2020, the Treasury Department ("the Treasury) and Internal Revenue Service("IRS") issued proposed regulations under sections 263A, 448, 451, 460, and 471, implementing the tax accounting provisions for small businesses contained in the Tax Cuts and Jobs Act. On August 20, 2018, the Treasury and IRS issued Rev. Proc. 2018-40, 2018-34 I.R.B. 320, which contained administrative guidance with respect to the implementation of these provisions and asked for comments with respect to future guidance that might come in the form of proposed regulations. These proposed regulations contain that guidance.

On September 12, 2018, we filed comments in response to Rev. Proc. 2018-40, and in those comments, we recommended that future proposed regulations adopt certain substantive provisions with respect to the implementation of the TCJA changes to sections 263A, 448, and 471. Most of our suggestions were rejected in these proposed regulations, and we ask that our prior comments (copy attached) be included in the record with respect to these proposed regulations.

We appreciate this opportunity to provide additional comments with respect to these proposed regulations. By separate letter, we are requesting that a public hearing be scheduled on these proposed regulations and that we be afforded an opportunity to testify. In that letter, we provide an outline of our proposed testimony.

1717 K Street, NW, Suite 600
Washington, DC 20006-5343
phone: 202.393.7600
fax: 202.393.7601
www.ipbtax.com

Summary of Comments

Our comments mainly relate to the following four subjects that we addressed in our prior comments:

1. Inventory in the form of raw materials of a qualifying small business taxpayer that the taxpayer elects to treat as non-incidental materials and supplies may be considered "used or consumed" and, hence, deductible, when the raw materials are used or consumed in the course of production of work-in-process and finished goods, rather than when the finished goods are completed and sold to a customer.

2. Purchases of inventoriable goods and components by a qualifying small business taxpayer that the taxpayer elects to treat as non-incidental materials and supplies should be eligible for the de minimis exception in Treas. Reg. § 1.263(a)-1(f), so that the cost of these de minimis materials and supplies may be deducted at the time of their purchase, provided they otherwise satisfy the requirements in Treas. Reg. § 1.263(a)-1(f).

3. The cost of inventory produced by a qualifying small business taxpayer that the taxpayer elects to treat as non-incidental materials and supplies and that the taxpayer elects to exclude from the application of section 263A should be required to include only direct material costs. Direct labor and overhead costs incurred to produce the inventoriable goods should be excluded from the cost basis of the goods and may be deducted as paid or incurred.

4. The cost of fixed assets and non-inventory property produced by a qualifying small business taxpayer that the taxpayer elects to exclude from the application of section 263A is permitted to be limited in terms of its capitalized costs to direct material costs, direct labor costs and variable overhead costs directly associated with the production of property used in the taxpayer's trade or business. Fixed overhead costs and general type overhead costs like general and administrative costs should be deductible as paid or incurred.

Detailed Comments

1. When are raw materials considered to be used or consumed

A. Background

The first area on which we wish to comment relates to when inventory in the form of raw materials of a qualifying small business taxpayer that the taxpayer elects to treat as non-incidental materials and supplies may be considered "used or consumed" and, hence, deducted for tax purposes. In our previous comments, we recommended that the raw materials that the taxpayer

elects to treat as non-incidental materials and supplies be considered used or consumed and, hence deductible, when the raw materials are used in the production process.

The proposed regulations reject that suggestion and propose to treat a taxpayer's raw materials as used or consumed (and hence deductible) when the production of the goods in which the raw materials are used is completed and the goods are sold to a customer. The preamble to the proposed regulations offers two explanations for this proposed treatment.

First, the preamble notes that the treatment required for small business taxpayers under the administrative guidance in effect prior to the enactment of the TCJA provided that inventory treated as incidental materials and supplies was not deductible until the production of the goods in which the materials and supplies were used was completed and the goods were sold to a customer. See Rev. Proc. 2001-10, 2001-2 I.R.B. 272, § 4.02; Rev. Proc. 2002-28, 2002-28 I.R.B. 815, § 4.05. The preamble cites to a passage in the legislative history of the TCJA indicating that Congress intended to codify the existing administrative rules and expand them to cover taxpayers with average annual gross receipts not in excess of $25 million. Accordingly, since the IRS treated raw materials as used or consumed only after the finished goods were sold under its prior administrative guidance, the preamble asserts that this is necessarily the required rule under the TCJA provisions.

Second, the preamble to the proposed regulations asserts that the Treasury and IRS have concluded that inventory of a small business taxpayer that is treated as non-incidental materials and supplies under the small business provisions does not lose its character as inventory property. Thus, the preamble reasons that since the cost of inventory property is normally not deductible as cost of goods sold until the inventory is sold to a customer, inventory treated as non-incidental materials and supplies under the small business provisions should be treated in the same manner.

We respond to these arguments below with both policy and legal arguments.

B. Policy considerations

First, from the point of view of policy, it is quite apparent from the legislative history of TCJA that the Congress viewed these tax accounting provisions for small businesses as intended to simplify inventory procedures for small businesses. From that point of view, Congress could only have intended to liberalize the current inventory rules as they apply to a small business that makes the election under this section. However, the proposed regulations' interpretation of these provisions would have exactly the opposite effect.

If raw materials of a small business taxpayer that the taxpayer elects to treat as non-incidental materials and supplies are not considered used or consumed until the product in which the raw materials are incorporated is completed and sold to a customer, and the raw materials are

ineligible for the de minimis exception in Treas. Reg. § 1.263(a)-1(f) (next comment), then the cost of the raw materials would be deductible at precisely the same time as when they were deductible as regular items of inventory, prior to the enactment of TCJA. Moreover, prior to the enactment of TCJA, a small business taxpayer could use either the cost method, the lower of cost or market method, or the LIFO method to determine the cost of its inventory. In contrast, under the small business provisions in the TCJA, the latter two methods are prohibited in the interests of maintaining administratively simplicity. Prop. Reg. § 1.471-1(b)(4)(ii).

While we have no objection to the latter restriction, the net result of the proposed rules dealing with the "used or consumed" requirement and the availability of a de minimis election under the proposed regulations is that a small business taxpayer that elects to treat inventory as non-incidental materials and supplies is treated less favorably under the TCJA, or at least no more favorably, than the taxpayer was treated prior to the enactment of the TCJA. It seems difficult to imagine that this is the result that Congress intended in a relief provision. Moreover, since the lower of cost or market method and the LIFO method for inventories are both elective methods under sections 471 and 472, and a small business taxpayer could always have declined to elect those methods in the interest of administrative simplicity without regard to the TCJA provisions, why would any small business taxpayer elect to treat inventory as non-incidental materials and supplies?

We submit that the only way to justify Congress's enactment of the small business provision relating to inventory is to interpret the provision as conferring some type of tax benefit on an electing small business taxpayer. In the context of the rules permitting non-incidental materials and supplies to be deducted when they are used or consumed, the only way to provide electing taxpayers with a tax benefit is to permit the taxpayer to treat raw materials as used or consumed when they are used in the production process, rather than when the finished goods in which the raw materials are incorporated are sold to the customer. The same point is also made for the de minimis exception, which is discussed separately below.

C. Substantive considerations

The "used or consumed" standard for non-incidental materials and supplies is contained in Treas. Reg § 1.162-3(a)(1). This section provides:

> Except as provided in paragraphs (d), (e), and (f) of this section, amounts paid to acquire or produce materials and supplies (as defined in paragraph (c) of this section) are deductible in the taxable year in which the materials and supplies are *first* used in the taxpayer's operations or are consumed in the taxpayer's operations.

Emphasis added.

Thus, for non-incidental materials or supplies used or consumed in the production of an inventoriable good, the cost of the material or supply is treated as deductible at the point in time when the material or supply is used, not when the finished good is sold. The only thing that prevents the cost of the material or supply from reducing a taxpayer's taxable income in the taxable year in which the material or supply is consumed is section 263A of the Code. Under the uniform capitalization rules, the cost of materials and supplies is required to be included in cost of goods in the year in which the materials and supplies are used or incorporated. Treas. Reg. § 1.263A-1(e)(3)(E).

As a result, the cost of the materials and supplies that are used or consumed is deferred in the inventoriable cost of the inventoriable good in which the materials and supplies are used or consumed and are not deductible until the finished good is completed and sold to a customer by reason of the application of the UNICAP rules, not by reason of the rules governing the treatment of non-incidental materials and supplies in Treas. Reg. § 1.162-3. One thing is clear in this situation: the cost of the material or supply enters the cost of the finished good in the taxable year in which the material or supply is used or consumed to produce that finished good, not in the taxable year in which the finished good is completed and sold to the customer.

However, if a small business taxpayer elects to be excluded from the inventory rules and the uniform capitalization rules, there is no statutory basis for deferring the cost of the incidental material and supply beyond the point in time when the material or supply is used or consumed. The only statutory basis for deferral at that point in time is section 263A and that section is inapplicable if a small business taxpayer so elects. To the extent pre-TCJA guidance is inconsistent with that conclusion, such guidance was erroneous and should be revised in these regulations.

In conclusion, regardless of whether the non-incidental material or supply retains its character as inventory, which seems totally in conflict with the statute, the only basis for further deferral of the cost of the material or supply is section 263A, and that section is specifically inapplicable if a small business taxpayer so elects. Accordingly, the final regulations should reverse the decision in the proposed regulations and provide that raw materials treated as non-incidental materials are considered used or consumed as they are used in the production process of making finished goods and should be deductible at that point in time, not when the finished goods are sold to a customer.

2. Eligibility of non-incidental materials and supplies for de minimis election in Treas. Reg. § 1.263(a)-1(f)

A. Background

The second area on which we wish to comment relates to whether purchases of inventory that the taxpayer elects to treat as non-incidental materials and supplies are eligible for the de minimis exception in Treas. Reg. § 1.263(a)-1(f).

For many years, taxpayers contended that it would clearly reflect income if they adopted a method of accounting whereby the taxpayer took a deduction for relatively low-cost property (including fixed assets and non-incidental materials and supplies) at the time of acquiring that property. After considerable controversy, the IRS and Treasury adopted a de minimis exception from capitalization in the repair regulations and required that a taxpayer extend that treatment to include non-incidental materials and supplies. Treas. Reg. § 1.263(a)-1(f); Treas. Reg. § 1.162-3(f). That exception enables a taxpayer to deduct purchases of property, including non-incidental materials and supplies, provided each unit of property costs less than $5,000 ($2,500/unit for taxpayers without an AFS) and provided the taxpayer deducts such purchases in its applicable financial statements.

In the proposed regulations implementing the TCJA, small business taxpayers electing to treat inventory as non-incidental materials and supplies are not permitted to utilize the de minimis exception for such inventory. We object to that exclusion from the de minimis exception.

B. Reasons for objection

As noted in the preceding section dealing with the "used or consumed" standard, we explained that without eligibility for the normal "used or consumed' standard and the de minimis exception in Treas. Reg. § 1.263(a)-1(f), an election to treat inventory as non-incidental materials and supplies is no different than its prior treatment as inventory. What would be the point of providing more liberal treatment of inventory by a small business taxpayer if that treatment ended up being exactly the same as under prior law? Surely Congress intended some liberalization in treatment. For that reason alone, taxpayers ought to be permitted to use the de minimis exception in Treas. Reg. § 1.263(a)-1(f) for inventory that the taxpayer elects to treat as non-incidental materials and supplies.

A second reason why eligibility for the de minimis exception should be permitted for electing small business taxpayers is that the reason cited in the preamble to the proposed regulations that Congress did not intend to broaden the treatment of inventory as non-incidental materials and supplies by small business taxpayers does not apply to the de minimis exception. That exception did not exist when the administrative provisions for taxpayers with gross receipts

not in excess of $10 million were first adopted and there is nothing in any of the IRS's official pronouncements indicating that such exception is not applicable to small business taxpayers.

Moreover, the proposed regulations are flatly inconsistent with the Joint Committee's General Explanation of the Tax Cuts and Jobs Act (the so-called "Blue Book"). A footnote to the Blue Book states:

> As the provision allows a taxpayer to treat inventories as non-incidental materials and supplies, a taxpayer may also be able to elect to deduct such non-incidental materials and supplies in the taxable year the amount is paid under the de minimis safe harbor election of Treas. Reg. sec. 1.263(a)–1(f).

Id. at 113, n. 465.

Accordingly, it is difficult to imagine a clearer case where the proposed regulations adopt a position in conflict with Congressional intent. There is absolutely no justification for excluding inventory that a small business taxpayer elects to treat as non-incidental materials and supplies from the de minimis exception in Treas. Reg. § 1.263(a)–1(f).

3. Determining the cost basis of inventory that is excluded from the application of section 263A

A. Background

A third issue that needs to be addressed is how to determine the cost basis of inventory produced by a small business taxpayer that elects to treat the inventory as non-incidental materials and supplies and to exempt such materials and supplies from section 263A. Under section 263A, the cost of materials and supplies produced by a taxpayer is determined pursuant to the principles in section 263A. Treas. Reg. §§ 1.263A-1(b)(11); 1.162-3(b).

Prior to the enactment of section 263A, the rules governing the costing of inventories (at that time contained in Treas. Reg. § 1.471-11) applied only to manufacturers of inventory and not to the production of materials and supplies. Accordingly, an issue was posed by the enactment of the TCJA as to how a small business taxpayer that elects to be excluded from section 471 and section 263A is required to determine the cost of inventory that is treated as non-incidental materials and supplies.

The proposed regulations answer this question by requiring only the direct costs of acquiring or producing the materials and supplies to be capitalized. That means that both direct materials and direct labor are required to be capitalized, but not any overhead costs. The preamble

suggests that this treatment was not required by the statute, but that this position is adopted in the interests of simplification.

B. Reasons for objection

As noted in our prior comments, the law prior to the enactment of section 263A supports the position that only direct material costs were includible in the cost of materials and supplies produced by a taxpayer. As discussed in our prior comments, section D of Notice 88-86, 1988-2 C.B. 401, suggests that when an architect produces blueprints, which are treated as materials and supplies and not inventory, the architect's time devoted to the production of the blueprints would not be part of the cost of the blueprints. The only costs that would be taken into account in determining the cost of the blueprints would be the paper and ink used to produce the blueprints. Such a conclusion would be consistent with the way the cost of materials and supplies produced by professionals, such as a brief prepared by an attorney or workpapers prepared by an accountant, is determined.

Based on the foregoing analogies, we submit that the proposed regulations do not go far enough in excluding overhead costs from the cost of inventory treated as non-incidental materials and supplies and excluded from section 263A by an electing small business taxpayer. Instead, labor costs should likewise be excluded, so that the only cost of materials and supplies that must be taken into account in these circumstances is direct material costs.

4. Determining the cost basis of fixed assets that are excluded from the application of section 263A

A. Background

A fourth issue that needs to be addressed is how to determine the cost basis of fixed assets produced by a small business taxpayer that elects to be excluded from section 263A. The standard adopted in the proposed regulations under the TCJA is to look to the law in effect prior to the enactment of section 263A.

Unfortunately, that approach does not lead to a clear answer in the case of the costing of fixed assets constructed by a taxpayer. As noted in the legislative history of the Tax Reform Act of 1986, prior to the enactment of section 263A, different costing rules applied to different asset categories, and the law governing the costing fixed assets was hardly uniform. Gen. Explanation of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100th Cong., 1st Sess., 504, 509 (1987). As noted in this legislative history, in *Adolph Coors Co. v. Commissioner*, 519 F.2d 1280 (10th Cir. 1975), cert. denied 423 U.S. 1087 (1976), the court required the full inclusion of all overhead costs in the cost basis of fixed assets constructed by a taxpayer, whereas in *Fort Howard Paper Co. v.*

Commissioner, 49 T.C. 275 (1987), the Tax Court held that an incremental costing method was equally acceptable with a full costing method.

B. Suggested Approach

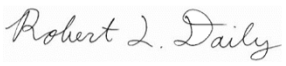
We recommend that small business taxpayers that have elected to be excluded from section 263A be permitted to use an incremental costing method to determine the costs of self-constructed assets. Since such taxpayers are excluded from the application of section 263A, it would be much simpler for such taxpayers to identify only those indirect costs that are directly attributable to the construction of particular assets and include only those costs in the basis of fixed assets. This is the approach adopted in the *Fort Howard Paper* case. In contrast, it would be burdensome if such taxpayers were required to allocate general type overhead costs, such as depreciation, property taxes, general and administrative costs, etc., to be capitalized to particular assets produced by a taxpayer.

We appreciate this opportunity to comment on the proposed regulations and are willing to discuss our suggestions with you and answer any questions you may have.

Sincerely yours,

Leslie J. Schneider

Patrick J. Smith



Robert Daily

Ivins, Phillips & Barker

Enclosure