UNITED STATES DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE

PUBLIC HEARING ON PROPOSED REGULATIONS
26 CFR PART 1

"ALLOCATION OF COSTS UNDER THE SIMPLIFIED METHODS"

[REG-126770-06]

Washington, D.C.
Monday, January 7, 2013

PARTICIPANTS:

For IRS:

CHRISTOPHER CALL
Staff Attorney
Income Tax and Accounting

DONNA CRISALLI
Senior Counsel
Income Tax and Accounting

ROY HIRSCHHORN
Branch Chief
Income Tax and Accounting

TOM MCELROY
Senior Technician Reviewer
Income Tax and Accounting

For US Treasury:

ALEXA CLAYBON
Attorney Adviser
Office of Tax Policy

Speakers:

LESLIE SCHNEIDER
Ivins Phillips & Barker

* * * * *

PROCEEDINGS

(10:00 a.m.)

MS. CRISALLI: Good morning. We're going to get started. This is the Public Hearing on proposed regulations Under 263(A) and 471 dealing primarily with using negatives in computing additional Section 263(A) costs under the simplified production method. My name is Donna Crisalli. I am a Senior Level Counsel in Income Tax and Accounting. Everyone on the panel this morning has been involved with the regs either as a draft or a reviewer. To my immediate right is Roy Hirschhorn, who is a Branch Chief in Income Tax and Accounting. To his right is Christopher Call, an attorney in Roy's branch. To my immediate left is Tom McElroy, who is Senior Technician Reviewer in Income Tax and Accounting. To his left is Alexa Claybon, who is an Attorney Adviser in the Office of Tax Policy.

We only have one speaker scheduled this morning and he will have 10 minutes to make his presentation. We have a timer here with handy red, yellow, and green lights. When we are down to 3 minutes, the yellow light will come in and at the end of the 10 minutes the red light will come on. Any questions that the panel asks during the presentation will not count toward the 10 minutes.

If anyone else in the audience wants to speak, you will have an opportunity to do so after the scheduled speaker, but please register in the entrance with Miriam if you want to do that. The Internal Revenue Service does not keep a transcript of the proceedings but the Tax Services do publish transcripts. I think that that's all of the opening formalities. Mr. Schneider?

MR. SCHNEIDER: Thank you for the opportunity to testify. My name is Les Schneider and I'm with the law firm of Ivins Phillips & Barker. I guess it's only fitting since we were the only ones to submit comments in 2007 that we're the only ones testifying today.

I think the problem with the issue of negative Section 263 costs as we pointed out in our original comments is that it really derives from the broader question, which is, what is the right way to allocate positive additional Section 273(A) costs? I think the problem that was created by the original simplified production method, if you will, was that the way the formula was phrased, it really wasn't that apparent to a lot of people exactly what was happening inside of the formula. I think the more traditional way that companies look at this issue is they say, here are the additional Section 263(A) costs that I've incurred for the whole year and now what fraction of those costs should I capitalize?

Conventionally you might think the way this happens under a facts-and-circumstances method is that the costs are allocated through a standard cost system to the individual items so that the fraction that gets capitalized is embedded in the cost of each item and no one really adds up all of those costs to say, in total, how much of the fraction of the total cost does that capitalize? But when you think about what's happening inside that formula, what you're really doing is taking an inventory turnover measure and you're saying with respect to any given cost that's incurred during the year, the fraction of it that's capitalized in total is based on the turnover that that cost experiences. The problem with the simplified production method is in order to have rough justice, it capitalizes the amount that is based on the total inventory turn of the items so that from the moment you buy the raw material to the point when you sell the goods, every cost is considered to have the turnover that is implicit in that entire production cycle. The problem is that for most people, because full absorption regulations were in existence before UNICAP, people were already capitalizing almost all of the costs at the early stage of the cycle, which is the raw material stage, but they weren't capitalizing a lot of the overhead costs that had to be capitalized. When you took just those additional costs that had to be capitalized that you weren't already capitalizing and you apply the turnover formula that was based on the turnover of the entire inventory cycle, everyone will acknowledge you are overcapitalizing most of if not all of the additional 263(A) costs.

Our suggestion was, if you think there's a problem because when you have less tax costs than book costs you have a negative additional 263(A) cost, you think you're taking out more than you put in in your book system, that's caused by the effect that the method has on positive 263(A) costs, so fix the formula for the positives and you'll take care of the problem for the negatives. That's what we suggested. In the lead-up to the notice and then following that, when I talked about this issue with the IRS it was obvious that the difference in turnover rates splits us between raw materials and costs related to raw materials and costs that enter the production process once processing begins. The easiest way to deal with that was to leave raw materials out of the multiplicand in the simplified production method and multiply the absorption ratio that the IRS developed against work in process and finished goods inventory. People said, then you're going to get a benefit compared to the facts-and-circumstances method because there are potentially 263(A) costs that relate to raw materials. My reaction is, that's rough justice. There aren't that many costs that people weren't already capitalizing that relate to raw materials and that would have been the easier way to do this. But given that the IRS objected to that under the chance that someone does have 263(A) costs related to raw materials, what they've developed here is a dual burden rate which follows the methodology that I'm describing for raw materials and separates the additional 263(A) costs for those compared to those that relate to work in process and finished goods. That obviously requires you to remove from work in process and finished goods the raw material element of it, which not everyone's cost system can do. There are a number of sophisticated cost systems that can do it, but not every taxpayer has those, so that this method is limited help. It helps those that can use it and doesn't help maybe smaller companies with less sophisticated systems. Where you come out on that depends on how far you want to go in making the simplified method exactly equate to the facts-and-circumstances method or just accept rough justice and make it very simple.

The same problem that exists with respect to additional 263(A) costs generally is, I think, embodied in the proposal with respect to mixed service costs. Mixed service costs are generally labor-based costs. You tend not to incur mixed service costs with respect to the cost of the raw material. Maybe there's a little bit of labor in raw materials associated with purchasing and things like that, but there is very little labor in raw materials, so that you would think that most if not all of mixed service costs would be allocated to the production cycle and a much easier way to deal with this issue I think would have been to simply allocate them directly to the second ratio, which is the production cycle ratio. In our comments we suggested an alternative which was that in those cases where someone does have some preproduction costs that they are allocating pursuant to that ratio, let that amount of cost compared to the rest of the production additional 263(A) costs drive the allocation of mixed service costs, but in that fashion many people won't have to have a second ratio and you still have a single production cost ratio like you have now but a fairer and more balanced ratio. That would be the way we dealt with mixed service costs.

For negative costs, the question is you acknowledge costs are being overcapitalized when you have positives. Whether you think as a result that means you're overremoving costs when you have negatives, it strikes me that as long as, for example, the net effect of your method change is positive and the simplified method capitalizes more costs, the fact that you're taking out more negatives than maybe you put in through your internal cost accounting system doesn't trouble me because you're putting in more additional positive 263(A) costs to counterbalance that. It's only in the rare case, I think, where you have net negative overall 263(A) costs that you could say somehow you've being benefited by the formula that exists today. My reaction is you can count on two hands the number of companies in America that have that situation. It's not that common that someone is going to capitalize on a gross overall basis more costs for books than they need to capitalize for tax.

With respect to cash and trade discounts, there is a rule in the proposed regulations that they can't be treated as additional 263(A) costs and I think that rule, I'm speculating, was put in there because of sales-based vendor allowances because on those kinds of allowances by using the 263(A) simplified formula you get the benefit of removing those vendor allowances even though they relate to nothing that is in the inventory. As a result I think this rule was put in there to protect the IRS against people using the simplified method to take sales-based vendor allowances out of book costs. It strikes me that depending on how you come in that regulation's project, you don't really need this rule for all the rest of cash discounts and trade discounts that are not sales-based vendor allowances and that, for those, the way people account for discounts is that when they post the purchase to their inventory account, the person that's posting that purchase doesn't know what kind of a discount or allowance they're being granted, it's not on the invoice in a lot of cases, so that most people track purchases of raw materials at the gross price and they wait until the end of the year to reduce their ending inventory by those discounts. No one is in a position to match item-by-item what those discounts relate to because they post it in gross to an account maybe weekly or monthly so that anyone that's using any kind of a system where they have to reduce their ending inventory by the discounts incurred throughout the year are going to be using some type of averaging method, and it strikes me that leaving aside sales-based vendor allowances, the formula in the simplified method is as good as any averaging method you would devise under 471 for removing those costs so that it strikes me that you don't really need a special rule in the regulations for cash and trade discounts.

Finally, with respect to other 471 costs, I think here there is a major administrative problem that the IRS is biting off without maybe realizing the problem they're creating. An awful lot of people don't include some types of direct costs in their book 471 costs. Variances on direct costs is one big category. There are a lot of fringes on labor costs that don't go into direct material costs and a lot of direct labor in a lot of companies, and to force somebody who's on the simplified method to deal with those separately and put them back into the 471 cost system, which implies item-by-item tracking when they're not doing that for books, I think is an unnecessary complication for a problem that is not a significant problem ,so that I would eliminate that rule. Thank you. Does anyone have any questions?

MS. CRISALLI: Questions from the panel?

MS. CLAYBON: The first suggestion about changing the modified simplified correction method: taxpayers that have capitalized labor preproduction costs would not be required to allocate any mixed service costs to the preproduction side?

MR. SCHNEIDER: If they're already capitalized off books, yes, so that they would only need one ratio like they have now.

MS. CLAYBON: The second suggestion that you had for the application of the modified simplified production method for taxpayers, do you characterize that as a more accurate reflection or a simplification? The first method you said may be less accurate but is much simpler and much easier to apply. The second suggestion seems the reverse, more complicated although potentially more accurate. Do you think that it would be more accurate?

MR. SCHNEIDER: It depends on how you want to look at the simplified method. Under the simplified method you're taking the costs for the year even though under the LIFO method you have an increment method that takes into account incurring costs, the costs, say, in the first quarter if you're on earliest acquisitions costs. If you're using the annual amount of 263(A) costs and not just the 263(A) costs from the first quarter, it strikes me that using an annual average to decide what fraction of the 263(A) goes into any increment is as accurate as the method that's used to determine what the fraction is. It strikes me as not really necessary to go to the extreme of using an increment averaging method that isolates the costs just for the increment period if you're on LIFO because you're not using that method to calculate the total amount of costs to be capitalized in any event. That's something you would do if you're on the facts-and-circumstances method. I would say using an annual average is probably fine and most people are not going to think that their costs fluctuate so much on 263(A) during the year that it's going to matter whether they use the increment period or the whole year so that I think the average for the whole year is probably easier.

MS. CLAYBON: Can you describe what you think are the barriers for taxpayers to adopting the modified simplified production method? What are the book differences? What are the recordkeeping problems? Who is going to not be able to do it?

MR. SCHNEIDER: As it's now drafted you do need to be able to separate the raw material content from the labor and the overhead content of work in process in finished goods. I think people are using SAP and Oracle and any one of those more sophisticated enterprise software systems have that information. It's built into their system because they know the material, labor and overhead content of every single product and the computer would add up all of the labor and the overhead and separate it from the material and get a total. For people who don't have those systems, it's less clear whether they could in effect do that separation and decide that inside of my work in process and finished goods there is this much raw material and therefore that should be subjected to the first turnover ratio whereas the labor and the overhead gets this production cost ratio. I think there is a barrier. There is no question that there is a body of taxpayers who probably can't do that separation. The choices are modify the formula and make it even simpler or leave them with the old formula and they get overcapitalized I guess is the bottom line.

MS. CRISALLI: Questions?

MR. HIRSCHHORN: Les, I have a quick question. This may be tagging onto Alexa's question. Allowing the taxpayer to have a choice to insert a smaller period in the denominator to replace taxable year, you site the consolidated regs for some kind of precedent. Do you want to explain that a little bit more?

MR. SCHNEIDER: With respect to a FIFO taxpayer the formula is measuring the turnover on a FIFO basis and saying that if my inventory turns over four times a year, one-fourth of my year's costs is being capitalized, and now you're saying I'm going to refine that and say I'm going to have two turnover ratios, one for raw materials which turns over at a slower rate and a second turnover ratio for costs that relate to WIP and finished goods which turn over quick because they're not in the production process as long. The question is now you have somebody who's on LIFO and they don't have their ending inventory on FIFO as their ending inventory, they have a much smaller amount, which is their increment, so the question is, for that increment what fraction of the increment should get 263(A) on it? You could say that the easiest way to do that would be to say it's the same fraction of FIFO but applied to LIFO so that every dollar that gets into the FIFO inventory has an equal chance of getting into the increment. When the consolidated return regulations were written I guess the IRS consulted with us and asked us where the same question arises for deferred intercompany profit where you have one affiliate that buys inventory for another and there is profit in those sales, how do you decide how much profit is in the buying member's ending inventory? You could do it one of two ways according to the way the regulations were developed. You could say I'm going to average all of my profit over all of my sales throughout the whole year and say that if my average profit on all intercompany sales is 2 percent to the extent I have intercompany sales goods in the inventory, 2 percent of that inventory cost is profit and you defer that. The alternative is to say if I'm on LIFO I'm not taking into account all of my costs for the whole year. I might be on the earliest acquisitions method or the latest acquisitions method and so I only have costs from the first turnover of the year or the last turnover of the year in my ending inventory. What if I sold inventory at the beginning of the year with profit in it and didn't sell any at the end of the year and I'm on the latest acquisitions method? You could say that a more precise LIFO method would say because only the costs in the last turnover of the year end up in my increment if I'm on the latest cost and costs in that period didn't have any intercompany profit on them because I'm going to measure intercompany profit to match my increment method, then I wouldn't have any intercompany profits to defer in that case. The rough justice method is to ask who is going to track their intercompany sales one by one throughout the whole year looking for the profit on each individual sale? Why not add them all up for the whole year, come up with an average intercompany profit rate and apply that to my ending inventory as rough justice? That's the choice that was faced in the consolidated return regs and they gave LIFO taxpayers two choices, a binding choice to pick either the more precise increment costing method or an annual average, and I'm saying you could do that here too.

MR. HIRSCHHORN: So you would say if we did give you the choice, it would be a binding choice?

MR. SCHNEIDER: Yes.

MR. HIRSCHHORN: Back and forth?

MR. SCHNEIDER: No. And you can't under the consolidated return regs either. I don't know that I've never seen anybody switch, frankly, once they've adopted one of the two methods.

MS. CRISALLI: Other questions from the panel? If I understood you correctly, you said at one point in your remarks that many small taxpayers would not be able to adopt the simplified modified production method because they lack the computer systems.

MR. SCHNEIDER: Yes.

MS. CRISALLI: There is a rule for small taxpayers in the regs. Do you think that that rule is inadequate?

MR. SCHNEIDER: I guess it depends on who you want to call small. My reaction is the rule for everybody maybe is more complicated than it has to be. I've never been that troubled by the idea that there are that many additional 263(A) costs that really relate to raw materials. I think if you go back in history, most people had to capitalize the costs that you would say the UNICAP regs required to be capitalized, the raw materials even before UNICAP, so that the slice of people who are affected at all I think is very limited. It's limited to people who probably weren't following the rules before so I don't know that there was all that many of those people to begin with. I'm not that troubled by the little piece of the 263(A) that maybe escapes being attached to the raw material costs in the raw state that occurs under the simplified method if it were modified in the more simple fashion. The other thing that's left unsaid throughout this entire analysis is what are the people doing who are on the facts-and-circumstances method or what are the people doing who are already treating these costs as part of their inventory for book cost accounting purposes? If you've talked to anybody who's on SAP, it's not so easy for SAP to allocate things like labor to raw materials on an item-by-item basis so that a lot of people who are already capitalizing costs related to raw materials in their inventory under their existing method so that it's not an additional 263(A) cost, a lot of them are already capitalizing it through overhead anyway so that it's not such a big leap to say, let everybody do that. The IRS doesn't see those cases because it's only when you come in for a method change that the IRS is hung up about this idea of whether someone is attaching a cost that truly relates to raw material to WIP and finished goods and as a result maybe a lesser fraction of it is being capitalized. A lot of people are already doing that through their facts-and-circumstances method and no one sees that because they're not applying for a method change. My sense is we're not talking about money here. It's really more a question of simplicity.

MS. CRISALLI: I find your comments interesting that there aren't a lot of negative 263(A) costs that would be attached to raw materials since it was your suggestion that we break out raw materials.

MR. SCHNEIDER: Only because the IRS suggested that they wouldn't go with the easier alternative.

MS. CRISALLI: To get back to my question, we have a $10 million threshold in the regs for a definition of small taxpayers who may use negatives. Do you think that that is too low?

MR. SCHNEIDER: I guess what I'm saying is I'm not saying it's too low. I think that the restriction on negatives is unwarranted for people -- yes, I would say it's too low.

MS. CRISALLI: What I'm asking is, would this encompass most of the small taxpayers who have the problem with the computer system?

MR. SCHNEIDER: No. I would say people with well in excess of $10 million would still have this problem.

MS. CRISALLI: Thank you. Are there any other questions? Thank you very much. Does anyone else wish to speak? Thank you very much for attending. That's the conclusion of the hearing.

(Whereupon, at 10:25 a.m. the HEARING was adjourned.)