NEW UNIFORM CAPITALIZATION AND LONG-TERM CONTRACT RULES

The Tax Reform Act of 1986 includes significant accounting changes with both apparent and hidden consequences. Many taxpayers will face unforeseen requirements for collecting data and making substantial adjustments.

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One of the centerpieces of the Tax Reform Act of 1986 is the provisions dealing with the uniform capitalization of inventory, construction and development costs and the accounting for long-term contracts. These are an unusually complex series of rules with direct and indirect implications that go well beyond what anyone could have imagined.

Capitalization Rules: Broad Scope

The new uniform capitalization rules are the most comprehensive costing provisions ever promulgated, and have been nicknamed the "super" full absorption costing rules because of the degree to which they would require indirect costs to be deferred either in inventory or in the capitalized cost basis of property.

Taxpayers Affected. The new uniform rules apply to both inventory and capital transactions. In the case of inventories, these new rules apply to manufacturers, thus supplanting the existing full absorption costing provisions in Reg. 1.471-11. In addition, the uniform capitalization rules apply to most wholesalers and retailers, and even to intangible property purchased for resale. The sole exception to these rules for wholesalers and retailers is for "small" taxpayers whose average annual gross receipts do not exceed $10 million. For wholesalers and retailers not meeting this limitation, the new rules represent a dramatic turnaround from prior law, where only the direct costs of acquiring goods held for resale were required to be inventoried.[1]

Under prior law, it was unclear whether taxpayers that acquired goods and reassembled or repackaged them without performing real processing activities were regarded as manufacturers subject to the full absorption costing requirement, or wholesalers and retailers for whom only direct material costs had to be inventoried. Such controversies should be ended under TRA'86, since the uniform capitalization rules will apply irrespective of whether such activities are regarded as manufacturing processes (assuming the $10 million limitation for small wholesalers and retailers is not applicable).

Property Covered. The uniform capitalization rules apply to the production or acquisition of property held for sale to customers even though such property would not be regarded as inventory.[2] This provision is intended to cover builders, developers and real estate dealers. Under prior law, such taxpayers were held not to be engaged in the sale of inventory within the meaning of Section 471, despite the fact that they were regularly selling to customers in the ordinary course of business.[3]

Property acquired or produced for personal use is exempted from the new rules. In addition, property acquired for investment rather than for resale also appears to be excluded. These exclusions are important in the real estate industry, where property such as an office building or shopping center is acquired for investment. Similarly, if raw land is purchased for investment rather than for development, it should be excluded from the uniform capitalization rules. Moreover, if the status of such properties changes at a later date, in the authors' view the basis of such properties should not be redetermined under the new rules. Property produced under a long-term contract is also technically excluded from these rules. However, as noted below, a more stringent version of the uniform capitalization rules applies separately under new Section 460.

An exemption for farming activities is limited to the raising of crops or livestock where the preproductive period does not exceed two years. However, farmers required to use the accrual method under Sections 447 or 448(a)(3) are not exempted. Taxpayers raising timber and certain ornamental trees are also exempted from the uniform capitalization rules.

Self-Use Property. In a dramatic change from prior law, the uniform capitalization rules are not limited in their application to inventories and inventory-like transactions; they also apply to the acquisition or construction of tangible property for use in taxpayer's own trade or business. Thus, for example, taxpayers engaged in the leasing business are subject to the uniform capitalization rules. In addition, such routine activities as the construction or rebuilding of plant and equipment, the undertaking of major repairs that are capitalized, and the repair of spare parts previously ex-

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pensed would all be covered by the new rules. The inclusion of these activities will present major compliance problems, since they are not normally accounted for under a cost accounting system for inventories.

Inventory Accounting. While these non-inventory transactions are covered by the uniform capitalization rules, this does not subject them to the favorable aspects of inventory accounting. For example, fixed assets may not be accounted for under either the lower-of-cost-or-market method or the LIFO method and, in addition, the practical capacity method (discussed below) may not be used in costing such non-inventory transactions. Thus, taxpayers may wish to consider whether to restructure their operations to take advantage of the favorable inventory provisions, where sales to customers and fixed asset accounting are presently combined.

For example, if a taxpayer both sells goods to customers and engages in leasing the same type of goods, such a taxpayer should consider separately incorporating the manufacturing portion of the business, so that all sales are made from the manufacturing affiliate either directly to customers or to a leasing affiliate. This should insure that both categories of goods receive favorable inventory treatment.[4]

Tangible and Intangible Property. Since the uniform capitalization rules only apply to purchases for resale of tangible property, the distinction between tangible and intangible property is important. Section 263A(b) provides that films, sound recordings, video tapes, books, and similar property are regarded as tangible property. However, taxpayers will still need to distinguish between the nature of the asset that is capitalized and the property that is produced and sold as inventory. For example, in the book publishing industry, the research and editorial costs protected by the copyright on a book would probably be regarded by IRS as the capitalized asset, while the printed books themselves would be considered to be inventory.[5]

Foreign Taxpayers. Although the uniform capitalization rules are silent on their application to foreign taxpayers, it seems certain that the new provisions are equally applicable to foreign and domestic taxpayers.[6] Thus, for purposes of Sections 902 and 964, foreign manufacturers and marketing subsidiaries will need to implement the uniform capitalization rules.

Related Changes. The uniform capitalization rules appear to have an effect in an area not contemplated by Congress. Since TRA '86 changes the definition of what costs must be included in inventory, the Service is certain to maintain that a comparable change must automatically be made in the definition of cost of goods sold and gross income. While the relationship between what costs are included in inventory and in the computation of cost of goods sold for gross income purposes was somewhat unclear under prior law, particularly for costs in Category Three of Reg. 1.471-11,[7] it seems likely that the very definitive uniform capitalization deferral rules will cause a great number of so-called below-the-line deductions to be moved above-the-line, so that they become part of cost of goods sold in determining gross income for all purposes of the Code.

The most significant change under the uniform capitalization rules is the treatment of overhead costs.

The implications of this conclusion are rather far-reaching, For example, the amount of installment sales deferral will shrink as gross profit is reduced. Planning for foreign tax credit utilization will also be drastically altered as deductions formerly allocated between foreign and domestic sources under Reg. 1.861-8 become part of the gross income calculation. Moreover, the collateral effect on gross income of the change to the uniform capitalization method of inventory costing may well have to be considered in measuring the amount of the transition adjustment under Section 481, where such collateral effect is related to timing adjustments.

Manufacturers and Producers of Property

The substantive impact of the uniform capitalization rules on particular taxpayers is influenced directly by the degree of cost capitalization or inventorying under prior law. In order to appreciate this impact, it is important to be familiar with both full absorption (Reg. 1.471-11) under prior law and the costing rules for extended-period long-term contracts in Regs. 1.451-3(d)(6) and (9).[8]

Direct Costs. New Section 263A (a)(2)(A) requires that all direct materials and direct labor costs be included in inventory or in the capitalized basis of fixed assets. Since this treatment of direct costs is comparable to that of prior law, examination of either the full absorption costing Regulations or the extended-period long-term contract costing Regulations should provide adequate guidance on what costs are considered to be part of direct materials or direct labor. Unless taxpayers are not in compliance with prior law, this provision should impose no change in treatment from prior law.

The lone exception may be in the case of sales taxes incurred in the acquisition of fixed assets, inventory or manufacturing supplies. The treatment of sales taxes in such cases was unclear at best under prior law. Although outside of the uniform capitalization rules, Section 164(a)(4) has been amended by TRA '86 to require that sales taxes paid or incurred in connection with the acquisition of property must be treated as part of the cost of the property.[9] Since most states and localities have sales and use tax resale exemptions, this provision probably has greater applicability to supplies and to self-constructed assets. It could, however, indirectly affect inventories.

Overhead Costs. The most significant change in law under the uniform capitalization rules is the treatment of overhead costs. While the statute is silent on precisely which overhead costs must be capitalized, the legislative history indicates that, with certain exceptions, the rules will be patterned after the cost inclusion rules for extended-period long-term contracts.[10] However, in light of the differences in terminology between construction and manufacturing, as well as due to the lack of guidance in the long-term contract Regulations as to certain costs, a number of judgments must be made at this time in evaluating which overhead

costs will be required to be capitalized or inventoried.

In the authors' judgment, virtually all overhead costs formerly contained in Category One and Category Three of the full absorption costing Regulations will be required to be capitalized or inventoried. With respect to Category One costs (*e.g.*, repairs and maintenance, utilities, rent, indirect labor and materials, expensed tools and quality control), the uniform capitalization rules appear to be a continuation of prior law for manufacturers. Accordingly, absent noncompliance with prior law, this provision should not have much of an impact on manufacturers. The prior law treatment of overhead costs in the basis of self-constructed assets, however, was far less certain or uniform.[11] Thus, it is possible that there will be a more significant impact on such activities.

In contrast, the mandatory inclusion of Category Three costs in inventory or in the capitalized basis of assets under the Act will have more of an effect on most taxpayers. The old book/tax conformity rules in Reg. 1.471-11 have been scrapped and the cost of all manufacturing and construction of property under the uniform capitalization rules must include the cost of taxes, depreciation and depletion, certain officers' compensation, insurance, employee benefits, and rework labor, scrap and spoilage incident to production or construction.

This mandatory cost inclusion for tax purposes has significant ramifications for financial reporting, as taxpayers and their outside accountants grapple with the question whether such overhead costs should also be deferred for financial reporting purposes. It should be anticipated that views on this subject will vary widely and it is unclear whether any comprehensive conclusion will be reached that will be universally applicable.

The question of book/tax conformity is even more significant in dealing with former Category Two costs. The uniform capitalization rules go well beyond the deferral of former Category Three costs; they also require the capitalization of several costs contained in Category Two of Reg. 1.471-11. First, all depreciation (including the excess of tax over book depreciation) must be allocated to deferrable costs, if it is incurred incident to production or construction activities. The Senate bill would have made this rule applicable only to the excess of tax over book depreciation on property acquired after 2/28/86. The Conference agreement dropped this limitation, however, so that the rule applies to accelerated depreciation on property regardless of when acquired.

Another cost required to be deferred under the Act is bidding expenses. However, if the job that is bid is not awarded to the taxpayer, the bidding costs may then be expensed. In the authors' view, product development and engineering costs outside of the scope of Section 174 must also be deferred under the new law. While there is a specific exception in Section 263A(c)(2) for Section 174 R&D costs, it is understood that this exception was not intended to apply to development costs outside of the scope of Section 174.

Storage and Handling. Under prior law, manufacturers had been successful in excluding from inventory any costs incurred beyond the point when the manufacturing process was completed. However, under the uniform capitalization rules, the costs of storing and handling both raw materials and finished goods up to the point of loading for final shipment to customers must be capitalized or inventoried.[13] This new cutoff point probably also captures transportation and handling costs from the factory to a forward distribution warehouse, although there is no discussion of this issue in the Committee Reports.

Administrative Costs. Another overhead cost which will pose a significant burden on taxpayers is general and administrative costs (G&A), including related officers' compensation. Under the uniform capitalization rules, an allocation of G&A, including home office G&A, must be made to production and construction activities. These G&A costs will include the costs of administration and coordination of production or construction, the personnel department, materials handling and warehousing, accounting and data services (*e.g.*, accounts receivable, accounts payable, billing, etc.), data processing, security services and the legal department. In contrast, G&A and officers' compensation related to overall management or policy functions (*e.g.*, business planning, general financial accounting, financial planning and budgeting, general economic forecasting, internal audit, shareholder and public relations and the tax department) may be expensed.[14]

However, because these divergent functions may not be isolated in separate cost centers, several levels of allocation might be required. In addition, taxpayers should be cognizant of the fact that management functions may be provided by a headquarters staff located in a separate corporation. A management fee must be allocated to the production or construction activities benefited and an imputed fee under Section 482 may appropriately be imposed in such circumstances. Such a fee would be subject to allocation to inventory or capitalized cost.[15]

[1] Reg. 1.471-3(b). These costs included the invoice cost of the merchandise less discounts plus freight-in and any other costs incurred in acquiring possession of the goods.

[2] Sections 263A(b)(1) and (2).

[3] See, e.g., W.C. & A.N. Miller Development Co., 81 TC 619 (1983).

[4] The sale to a leasing affiliate would be a deferred intercompany transaction; Reg. 1.1502-13. However, the timing of such a restructuring should take into account the differences in the transition rules for inventories and fixed assets. See discussion of these rules in the text.

[5] Rev. Rul. 73-395, 1973-2 CB 87. See also Schneider, 1 *Fed. Inc. Tax'n of Inventories* 1-10 (Matthew Bender, 1986). However, through depreciation of the fixed asset, a portion of the cost of the fixed asset should be allocated to the inventory produced.

[6] This is consistent with Rev. Proc. 79-39, 1979-2 CB 502.

[7] Ltr. Rul. 8130012. See also Schneider, *supra* note 5, at 5-37.

[8] See Schneider and Solomon, "Long-Term Contract Regulations: Endless Complexity and Planning Opportunities," 64 JTAX 274 (May 1986).

[9] In addition, sales taxes paid or incurred in the disposition of property must be treated as a reduction in the amount realized on the sale. This has the effect of treating sales taxes as a deduction in computing gross income, a departure from prior law. Rev. Rul. 67-307, 1967-2 CB 253; Rev. Rul. 79-196, 1979-1 CB 181.

[10] S. Rep't No. 99-313, 99th Cong., 2d Sess. 141 (1986).

[11] *Id.* at 136-37.

[12] H. Rep't No. 99-841, 99th Cong., 2d Sess., II-304 (1986).

[13] S. Rep't No. 99-313, *supra* note 10, at 142, fn. 40.

[14] Reg. 1.451-3(d)(9). However, if these types of G&A costs directly benefit production or construction, they must be deferred.

Interest Expense. The final item of former Category Two costs required to be inventoried or capitalized in certain circumstances is interest expense. The deferral of interest expense is more limited in scope than the uniform capitalization rules in general, as the interest deferral rules apply only to certain long-term production activities. These rules apply only to taxpayers producing tangible property, and then only if the property which is constructed or produced is real property or personal property with a class life of at least 20 years. In the case of personal property, it applies both to property held for sale and for use in the taxpayer's trade or business.[16]

The interest deferral rules also apply to the production of property regardless of its class life if it takes more than two years to produce the property or, if the property costs more than $1 million, if the production period exceeds one year. Because of these restrictions, outside of the long-term contract area discussed separately below, the interest capitalization rules probably have limited applicability to most manufacturers. In contrast, in industries where the product is aged over several years, such as in the liquor and tobacco businesses, the aging costs are treated as part of the manufacturing process under the Act, so that the interest deferral rules may apply.[17] If the interest deferral rules apply, they are intended to operate in a manner similar to old Section 189, using the cost avoidance approach. Thus, interest expense on debt directly secured by the production activity and interest on a portion of the taxpayer's general debt would be deferred.

With respect to the general debt, the amount of the taxpayer's inventoriable or capitalized costs would be deemed to be the amount of debt that could be avoided. However, if the manufacturer receives progress payments from a customer, they would reduce the amount of allocable debt. Instead, the customer would become subject to the interest capitalization rules based on the amount of progress payments made to the manufacturer.[18] The interest expense to be deferred on the amount of debt that could have been avoided would be based on the taxpayer's average interest costs.

Excluded Costs. In view of the comprehensive nature of the uniform capitalization rules, what costs remain deductible period costs? Such excluded costs would be the costs of marketing, selling, advertising, bidding on contracts not awarded, R&D under Section 174, losses under Section 165, depreciation on idle assets, income taxes, past service costs of pensions,[19] strike costs, G&A allocable to selling, R&D or policy functions, intangible drilling and mining development costs.

Contrary to most of the other accounting changes, the long-term contract changes are made pursuant to a cutoff transition rule.

Dealing With the New Rules. After a taxpayer maintaining inventories accumulates all of the additional overhead costs required to be included in inventory under TRA '86, the most difficult problem is determining what is required to be done with the additional costs. Based on discussions in the Senate Report and by implication in the Conference Reports, it seems clear that the additional overhead costs must be allocated to the individual items in a taxpayer's inventory.[20] If a taxpayer employs FIFO and its inventory turns over at least annually, allocation of overhead costs to particular units would not seem to be overly important. However, even with FIFO inventories, since Reg. 1.471-4(c) requires lower-of-cost-or-market comparisons to be made on an item-by-item basis, it seems likely that some type of item-by-item allocation would be required.

In the case of taxpayers using dollar-value LIFO product cost method, this problem is particularly troublesome. Under any of the dollar-value indexing methods, the cost of each item (or a sampling of items) must be double extended. "Cost" for this purpose logically must mean tax cost and the Service has ruled that so-called "topside" adjustments to the full absorption method under prior law were not acceptable.[21] Accordingly, it may be necessary to revamp every LIFO taxpayer's cost accounting system in order to develop revised item costs, and it may be necessary for taxpayers to develop new standard costs where that method of allocation is now employed. No guidance is provided in the legislative history as to the level of precision with which such allocations must be made. The Committee Reports suggest that the rules will be flexible.

Unfortunately, the simplified allocation methods for wholesalers and retailers (discussed in detail below) are expressly provided to be in direct contrast to the more detailed allocations that are expected of manufacturers.[22] Moreover, when this conclusion is considered together with the fact that book/tax nonconformity is likely to exist for at least some of the costs deferred under the uniform capitalization rules, it becomes increasingly likely that the new legislation will require the maintenance of at least two entirely separate cost accounting systems, with separate standards or burden rates for all individual items of inventory.

Practical Capacity Method. In considering what allocation rules to apply to the additional overhead costs that must be inventoried under the uniform

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[15] Reg. 1.451-3(d)(9)(v)(A).

[16] H. Rep't No. 99-841, *supra* note 12, at II-308.

[17] See note 13 *supra*. This represents a reversal of prior case law. See, *e.g.*, Heaven Hill Distilleries, Inc., 476 F.2d 1327 (Ct. Cls., 1973). Under the new rules, significant complexities may result in the computation of a price index if the taxpayer uses the dollar-value LIFO method. The transition adjustment may also be exceedingly complex in these circumstances.

[18] Section 263A(f); H. Rep't No. 99-841, *supra* note 12, at II-308.

[19] However, the Committee Reports caution that the distinction between the current and past service cost component of pension expense will be subject to special inventory definitions that do not necessarily follow the minimum funding rules of Section 412. S. Rep't No. 99-313, *supra* note 10, at 142-143. However, based on discussions with actuaries, until further guidelines are promulgated, it is safe to assume that no one has any idea what is contemplated in this area.

[20] S. Rep't No. 99-313, *supra* note 10, at 142; H. Rep't No. 99-841, *supra* note 12, at II-305.

[21] In Ltr. Rul. 8043023, the National Office concluded that the cost of each item that is double-extended under the dollar-value LIFO method must be computed based on its full absorption cost. In other words, it was not permissible to double-extend unit costs on a non-tax basis, and then merely add in the additional tax costs at the end of the index calculation. Moreover, the penalty for noncompliance with such interpretation was the termination of LIFO.

capitalization rules, one technique that all manufacturers should consider adopting is the practical capacity method. This requires a taxpayer to include in inventory only that portion of its fixed overhead costs that its actual level of production bears to practical capacity. While many taxpayers failed to adopt this method when the full absorption Regulations were promulgated because its benefits were inconsequential, under the new law reconsideration of this decision is in order. Since many of the additional costs required to be inventoried under the uniform capitalization rules are in the nature of fixed overhead costs, the use of the practical capacity method could be considerably more beneficial under the new law. However, taxpayers are cautioned that a change to the practical capacity method would generally be regarded as a change in method of accounting for which the Service's advance consent is needed.[23]

Wholesalers and Retailers

As noted above, one of the most radical changes made by the Act in the costing of inventories is to require all wholesalers and retailers (other than "small" taxpayers) to follow the new uniform capitalization rules. The Committee Reports provide that four basic categories of overhead costs must be inventoried by wholesalers and retailers. Previously, none of these costs were generally included in the inventory of wholesalers and retailers.

1. The costs of offsite storage and warehousing. For this purpose, offsite storage refers to a facility used primarily for storage, as contrasted with one used primarily for selling.[24] The Committee Reports also make it clear that the uniform capitalization method applies in determining the types of allocable storage costs. Thus, both the direct costs of the storage activities and an allocable share of G&A must be inventoried.

2. The direct and indirect cost of purchasing activities, such as buyers' salaries and commissions. In the authors' experience, some taxpayers have already inventoried such costs under prior law.

3. The costs of handling, processing, assembly and repackaging. Thus, the labor costs of unloading the goods at a warehouse must be deferred, but the costs of loading for final shipment to customers and the costs of operating a retail facility need not be deferred.

4. G&A attributable to the foregoing activities. Here again, the determination of which G&A costs must be allocated to inventory would presumably be determined with reference to the G&A allocation rules in the extended-period long-term contract Regulations discussed above.

While compliance with the new cost inclusion rules is likely to be very burdensome for manufacturers, it will be even more so for many wholesalers and retailers. Since wholesalers and retailers have not previously been required to inventory *any* overhead costs, there is a distinct lack of sophisticated cost accounting systems in place in these industries. Even taking into account the possibility of using the simplified overhead allocation methodologies discussed below, it will still be burdensome to accumulate and isolate the costs described above in order to apply the allocation rules. For many of the functions for which costs must be allocated to inventory, the functions are performed by employees of departments that also perform selling, marketing and distribution functions.

Thus, information reporting and revisions to organizational structures may well be necessary to facilitate compliance with these rules. Moreover, as noted above in the case of manufacturers, it seems unlikely that all of the overhead costs that would be deferred in inventory for tax purposes under the new rules would be treated comparably for financial reporting purposes. Thus, dual recordkeeping may become necessary for most wholesalers and retailers.

Simplified Allocation Methods. It was due in large part to the foregoing concerns that the Treasury was directed by Congress to develop simplified allocation methods for wholesalers and retailers.[25] The Committee Report makes it clear that such methods would be optional and that wholesalers and retailers could follow the allocation procedures applicable to manufacturers.[26] Unfortunately, the simplified methods described below amount to nothing more than the traditional burden-rate method, except that allocations of overhead costs to individual items of inventory seemingly are avoided.

Thus, this Congressional directive creates the adverse inference (as previously noted) that much more detailed and specific methodologies are required under the rules applicable to manufacturers.

The Committee Report contains a simplified allocation formula for wholesalers and retailers for each of the four categories of cost inclusion described above. Each formula involves the development of a ratio which is then applied to the category of costs to determine what portion of such costs must be allocated to inventory. In the case of a taxpayer using FIFO, such ratio would be applied to the total ending inventory value computed prior to the application of the new costing rules. In the case of LIFO taxpayers, the ratio determined under the formula would be applied only to the current year's LIFO increment, if any. Prior years' increments would reflect the application of the appropriate ratios for such prior years (*e.g.,* in the first year to which the new rules apply, the opening inventory would be revalued pursuant to Section 481, as described below, and for succeeding years increments existing in the opening inventory would reflect these additional "top side" adjustments).

The Committee Report indicates that such ratios would be developed separately by trade or business. For wholesalers and retailers using LIFO, since pooling is based on major product lines or departments rather than on separate trades or businesses, it is unclear whether the same ratio would be applied proportionately to all pools or whether there would be netting of offsetting increments and decrements in separate pools. In the authors' view, as an alternative to the methods provided, the Treasury should consider permitting the calculation to be made separately by pool or by product line.

In addition, the use of the simplified method for LIFO taxpayers basically attributes the inflation rate determined from material prices to the overhead component of inventory. This may be either a benefit or a detriment to taxpayers using this method, depending on whether the relative inflation in materials or overhead has been greater since adopting LIFO. Generally, taxpayers with higher inflation rates on

their materials will be disadvantaged in choosing the simplified approach. A few of the many more unanswered questions are how these rules would allocate the additional costs to individual items for purposes of the lower-of-cost-or-market method and how or whether these methods would be integrated with the retail method in instances where such method is used.

Calculations. The simplified formulas themselves are relatively straightforward. What is much more difficult is the process of isolating and accumulating the data in order to calculate the formulas. In the case of storage costs, the simplified formula would allocate storage costs to inventory based on the ratio of total storage costs for the year to the sum of the dollar amount of the year's beginning inventory balance plus gross purchases for the year. Purchasing costs would be allocated to inventory based on the ratio of the amount of purchasing costs to gross purchases for the year. Processing, repackaging, etc., would be allocated based on the ratio of the total amount of such costs for the year to the sum of the dollar amount of the beginning inventory plus gross purchases for the year.

In applying each of the foregoing ratios to the applicable category of costs, G&A costs must first be allocated to each such category. The simplified formula for such allocation is based on the ratio of the amount of direct labor dollars associated with each activity to the total gross payroll for the year.[27]

As noted above, these simplified formulas function like burden rates. In that sense, they seem to add very little simplification to procedures that would have been followed in their absence. Wholesalers and retailers will still have the problem of developing the data required by the formulas. For example, if direct labor costs in the formula for G&A has the same meaning as in the full absorption and extended-period long-term contract Regulations, such costs include considerably more than just basic compensation. Consider the effort necessary to redesign an accounting system because payroll taxes or vacation pay on direct labor are accumulated in an account that does not distinguish between purchasing labor cost and selling labor cost.

Moreover, the foregoing illustration might pose problems even with respect to the tracking of the basic compensation of direct labor employees. It seems highly unlikely that each of the activities that will be required to contribute costs to the valuation of inventory under the new rules will be self-contained in separate cost centers. In conclusion, it should be readily apparent that there will be nothing simple about the simplified methods, while the alternatives can only be much worse.

Transition Rules

The effective date provisions of TRA '86 are relatively straight-forward for self-constructed property and non-inventory property produced for sale, but contain a myriad of complexities for any property which is inventory in the hands of a taxpayer. Self-constructed property and non-inventory property are subject to a cut-off transition rule. Thus, only costs incurred after 1986 need be capitalized in the basis of such property. Furthermore, the new rules do not apply at all to property produced by a taxpayer for its own use if substantial construction on such property occurred before 3/1/86. This special rule grandfathers an entire facility if substantial construction occurred before 3/1/86, and also grandfathers self-constructed assets which are an integral part of the facility even if construction of such assets began after 2/28/86.

While non-inventory transactions are covered by the uniform capitalization rules, this does not subject them to the favorable aspects of inventory accounting.

Two issues appear immediately under this rule. First, what is "substantial construction" for purposes of this special rule? The Committee Reports do not define the term and there appears to be an absence of guidance in prior statutes. Second, what constitutes "use" by the taxpayer in order to meet the conditions of this rule? Non-inventory property (*e.g.*, real estate) may be produced for use by or sale to others.[28] Unless the taxpayer producing the property will also use such property after production, the costs incurred after 1986 which are covered by the new rules would have to be capitalized in basis even if substantial construction occurred before 3/1/86.

Inventory property is generally subject to the new rules for a taxpayer's first taxable year beginning after 1986. However, Congress rejected a cut-off transition rule for inventories and taxpayers are required to revalue their opening inventory for their first taxable year beginning after 1986 under these new rules. The change to the uniform capitalization method is treated as a change in method of accounting initiated by the taxpayer, and the resulting Section 481 adjustment is to be spread ratably over a period not exceeding four taxable years.[29] This transition rule creates a host of problems, some of which are addressed in the legislation, and others which were not even contemplated.

Current Noncompliance. The first question which must be answered is how this transition rule is intended to apply to taxpayers who are erroneously valuing their inventories under current law. Taxpayers not complying with the full absorption rules of Reg. 1.471-11 generally face stringent transition rules under *Rev. Proc.* 84-74, 1984-2 CB 736. Under such rules, once the taxpayer is under audit, no spread of the Section 481 adjustment would be permitted. In other situations, the filing of a request to correct the method would result in a spread period that does not exceed three taxable years.

TRA '86 does not distinguish between costs added to inventory in order to comply with the current law full absorption method and costs added to inventory to comply with the uniform capitalization method. Presumably, a four-year spread is available only for costs added to inventory in switching from the full absorption method to the uniform capitalization method. Since the spread period under TRA'86 is generally controlled by *Rev. Proc.* 84-74, any portion of the Section 481 adjustment which would not receive a spread period under the Procedure should not be entitled to a spread forward under the transition rule. This entire discussion, however, leads to the further unanswered prob-

lem as to whether the transition rule is intended to override the pre-1954 dropout provisions in Section 481(a)(2). Since TRA'86 treats all changes to the uniform capitalization method as voluntary,[30] the conflict with the current law pre-1954 protection is readily apparent.

Section 481 Adjustments. Once these preliminary transition issues are resolved, a taxpayer must calculate the amount of the Section 481 adjustment. Wholesalers and retailers using the simplified method outlined earlier must apply the simplified method to restate beginning inventory. For the balance of taxpayers, if FIFO is used, the Section 481 adjustment calculation should be relatively easy if overhead data by cost center has been maintained or is available for the last taxable year ending on or after 12/31/86. In the case of goods present in the opening inventory, but which are no longer acquired or produced by the taxpayer, such goods may have their cost basis redetermined on the basis of the most recent years' data that is available.

However, for LIFO taxpayers, the Section 481 adjustment calculation presents an accounting nightmare. Unless the short-cut transition rules discussed later are adopted, a taxpayer must apply the uniform capitalization rules described above to each year (including the base year) that the taxpayer has used the LIFO method. To obtain the correct mathematical result, it is necessary to perform the recalculation even for years for which there are no LIFO layers remaining at the revaluation date. In order to be able to make such recalculations, a taxpayer must be able to ascertain the amount of additional costs segregated by cost center for such prior years, as well as have preserved its item-by-item LIFO price index calculation for such prior years. Additional complexities result where the taxpayer has changed its inventory method over the Section 481 adjustment period.

LIFO taxpayers will likely find it difficult, if not impossible, to comply with the item-by-item revaluation for every LIFO year. For this reason, LIFO taxpayers are given a special three year "look-back" short-cut rule. However, such method is only available to such taxpayers if they lack sufficient data to compute the Section 481 adjustment precisely.

Short-Cut Method. Under the short-cut method, the uniform capitalization method would be applied to a taxpayer's last three taxable years for which there are increments remaining as of the year of change. The percentage increase in current-year costs due to the application of the uniform capitalization method would be determined for each of the three test years and a weighted average increase computed. This percentage would then be applied to all layers and a revalued LIFO inventory would be determined. This short-cut method has many benefits, but it also has several shortcomings.

On the positive side, it eliminates the need to recompute every LIFO year's inventory calculation, and it avoids the need to allocate the uniform capitalization adjustment to individual item costs. However, the principal weakness of the short-cut method is that it must be based on increment years, not taxable years. Thus, even the short-cut method might require a recomputation that looks back many years.

The use of the short-cut method also offers taxpayers the ability to adopt a new base year. However, depending on the relative mix of products and relative current-year cost of such products as compared to their relative old base-year costs, the use of the new base year may prove either beneficial or detrimental to a taxpayer. This new base year option presupposes insufficient data in prior years, but this fact may be one of degree and therefore the ability to adopt a new base year may be subject to planning in 1987.

The short-cut method also may potentially overstate or understate the Section 481 adjustment, depending on the increment layers used. More recent layers may tend to have larger adjustments. However, older layers from years prior to the promulgation of the full absorption Regulations may be even more undervalued relatively than recent years. Thus, it is impossible to assess in a broad fashion whether the short-cut method would operate to a taxpayer's advantage or disadvantage in this respect.

To ameliorate these averaging problems, while still allowing a short-cut method to be used, TRA '86 provides that a taxpayer, at its option, may revalue the current-year costs attributable to more than the three most recent LIFO layers in developing the applicable average revaluation factor. However, only consecutive layer years may be used.[31] Selecting such an alternative may allow the bulk of a taxpayer's inventory to be revalued under the actual experience method, while still providing the taxpayer with a new base year for purposes of future calculations.

Long-term Contracts

Under TRA '86 a new Section 460 is added to the Code to provide special rules in accounting for long-term con-

[22] Compare statement in S. Rep't No. 99-313, *supra* note 10, at 142, with the *optional* simplified allocation rules for wholesalers and retailers provided in H. Rep't No. 99-841, *supra* note 14, at II-305 et seq.

[23] Such a change would necessitate the filing of a Form 3115 within the first 180 days of the year of change. Rev. Proc. 84-74, 1984-2 CB 736. The Service consents to change on condition the taxpayer agrees to change to the practical capacity method for financial reporting purposes.

[24] H. Rep't No. 99-481, *supra* note 12, at II-306. The Committee Reports do not indicate on what basis (e.g., dollar volume of storage v. sales, space utilization, etc.) the primary use of a facility is determined.

[25] H. Rep't No. 99-481, *supra* note 12, at II-305.

[26] Query whether this includes the use of the practical capacity method?

[27] H. Rep't No. 99-481, *supra* note 12, at II-306 et seq.

[28] Compare Regs. 1.48-1(j) and (k).

[29] The timing rules of Rev. Proc. 84-74, *supra* note 23, apply, with the result that a spread period of less than four years may apply if the taxpayer has used the inventory method for less than four years. Also, the Conference Report specifically allows NOL carryforwards and tax credit carryforwards to offset any positive Section 481 adjustment resulting from this change despite the proscription of this generally in Rev. Proc. 84-74.

[30] Act Section 803(d)(2)(B)(i).

[31] S. Rep't No. 99-313, *supra* note 10, at 147-52; H. Rep't No. 99-841, *supra* note 12, at II-308.

[32] See Schneider and Solomon, *supra* note 8.

[33] Schloegl, TCM 1986-440.

[34] Reg. 1.451-3(d)(6)(ii)(Q).

[35] Section 460(c)(4)(A). In addition, this rule is retroactive in effect, thereby overruling prior Service policy in this area.

tracts. These rules represent a continuation of Congress' efforts (starting in 1982) to restrict the benefits of the long-term contract methods of accounting by requiring a greater percentage of costs to be allocated to long-term contracts.[32]

Who is Covered. Except for certain small construction contractors (as later defined), these new rules apply to all taxpayers with long-term contracts. It does not matter whether a taxpayer is currently using the completed contract method or either the cash or the accrual method to account for long-term contracts. In any of the above cases, the new rules apply. Moreover, even if the taxpayer currently uses the percentage of completion method, the percentage of completion method must be revised as described below.

The sole exception from these new rules is for long-term construction contracts involving the building, reconstruction or rehabilitation of, installation of any integral component to, or improvements of, real property where the contract will be completed in less than two years and is performed by a contractor whose average annual gross receipts for the preceding three years does not exceed $10 million. Attribution rules are provided for purposes of measuring this exemption. This exemption does not apply to taxpayers involved in the construction of property other than real property. If this exception does apply, it enables the contractor to avoid the new uniform capitalization rules and, instead, to use the non-extended period long-term contract rules of Reg. 1.451-3(d)(5). However, the interest rules in the new uniform capitalization rules would nevertheless apply to such an exempted contractor.

Definitional Issues. These rules will place great tension on the definition of a long-term contract as taxpayers grapple with varying fact patterns in trying to ascertain whether or not it is better for a contract to be considered a long-term contract. After much debate in Congress, the definition of a long-term contract in the new statute was not changed from prior law. Thus, much of the focus in taxpayer dealings with the Service will be on manufacturing contracts and the central issue of whether the subject matter of the contract is "unique."

In recent years, the Service has challenged the notion that highly specialized, custom-order products satisfy the uniqueness standard in the long-term contract Regulations if there are multiple units within the contract or if the taxpayer has produced the item on several prior occasions.[33] Since there are significant new adverse tax consequences that flow from a contract being categorized as a long-term contract, contractors should reevaluate their individual circumstances and reach a conclusion as to whether a particular contract would be better classified as a long-term contract or as a non-long-term contract. In many cases, there will be a sufficient legal basis to claim either classification. However, a taxpayer's prior treatment of similar contracts and accounting method considerations will need to be taken into account in assessing this flexibility.

Percentage of Completion Capitalized Cost Method

Under TRA 86, long-term contractors (other than those employing the percentage of completion method) must treat income and deductions under a long-term contract by accounting for 40% of the contract price and contract expenses pursuant to the percentage of completion method. The balance of the contract would be reported under the taxpayer's regular method of accounting (*i.e.,* these methods might include the completed contract method, accrual billing method, the accrual shipment method and cash method). A look-back method will apply to the 40% of the contract price accounted for under the percentage of completion method. Under this look-back method, interest is paid to or by the taxpayer on the difference between the 40% amount actually taken into account by the taxpayer for each year of the contract and the amount which would have been taken into account had 40% of the actual contract price and costs been used in determining the amount allocated to each year prior to completion.

Moreover, the amount to be reported under the percentage of completion method is based on a comparison of all contract costs incurred in a year to the total estimated costs (using the extended-period long-term contract costing rules). Thus, the use of relative direct labor costs, raw material costs, or engineering data to determine completion is no longer permitted under the new rules. Because of this fact, taxpayers may be faced with the problem of having completion accelerated merely by purchasing all of the raw materials at the inception of a contract. It might be appropriate in such a case to defer the inclusion of these raw material costs in the measurement of completion until such time as the material is actually used in the manufacturing or construction process.

The application of the 40/60 rule was obviously drafted with the completed contract method in mind and not for taxpayers currently using the cash or the accrual method. Accordingly, it is not clear how prior income inclusions under the 40% portion of the contract affect subsequent income inclusions prior to contract completion on the 60% portion of the contract.

For example, it is unclear whether the accrual of income under the taxpayer's regular method would be divided 40%/60% or income inclusions under the 60% portion could be applied dollar-for-dollar against prior years' percentage of completion income inclusions. Uncertainties also exist in the expense side of the issue.

For example, if the long-term contractor is using the accrual shipment method and the dollar-value LIFO method of valuing its inventory, it is unclear how such LIFO calculations would be affected by the 40%/60% income split. The complexities in this area are self-evident.

Cost Deferral Rules. The other significant impact of TRA '86 on long-term contracts is that the existing costing rules for extended-period long-term contracts will apply with certain modifications. These rules are essentially the same as the uniform capitalization rules described above, except that directly-related R&D expenses would be a deferrable cost.[34] However, independent research and development costs ("IR&D") would not be treated as a deferrable cost, nor would IR&D have to be severed from the main contract and accounted for separately.[35] Another excluded cost would be unsuccessful bid and proposal costs.

In addition, if the long-term contract is either a cost-plus contract or a Federal long-term contract, any other

costs of the contract (not capitalized under the general rules) which are identified as reportable under that contract must be deferred. This may cause the deferral of additional R&D costs and G&A expenses compared with prior law.

Finally, it should be noted that the interest deferral rules would probably apply to most long-term contracts. This is due to the fact that (except in the case of accrual-method taxpayers) all units under the contract would be treated as a single unit for purposes of applying the one-year production period and $1 million cost standard discussed above. As a result, particular attention should be devoted to the interest deferral rule.

Transition Rules. Contrary to most of the other accounting changes in the Act, the long-term contract changes are made pursuant to a cutoff transition rule. Under this rule, the new provisions apply to contracts entered into after 2/28/86. Thus, these rules are partially retroactive. In the case of accrual/inventory taxpayers, the disparity between the 2/28/86 effective date and cutoff transition rule and the 1/1/87 effective date and Section 481 adjustment transition rules under the uniform capitalization provisions is likely to entail significant complexities. This could pose particularly difficult computational problems where the inventory is contained in a single LIFO pool.

Conclusion

The new accounting provisions are extraordinarily complex and they pervade many different areas of the Code, affecting numerous types of taxpayers and transactions. Unfortunately, the effective dates leave little time for planning and present the very real problem that overwhelming amounts of calculations will need to be performed in a short time frame. ★

CA-5 HOLDS SALE OF STOCK CAN ONLY BE TREATED AS CAPITAL

Capital stock (held by any person other than a securities dealer) cannot be anything other than a capital asset under Section 1221, according to the Eighth Circuit in *Arkansas Best Corp. & Subsidiaries*, CA-8, 9/9/86. The court has thus narrowly construed *Corn Products*, refusing to extend that holding beyond its facts.

In the landmark case of *Corn Products*, 350 U.S. 46 (1955), the Supreme Court held that a sale of corn futures by a taxpayer who bought them to protect the supply and price of raw corn which it needed in its operations produced ordinary gain or loss. The Supreme Court held that the futures were an integral part of the business.

Arkansas Best was a diversified holding company which purchased 65% of the stock of the National Bank of Commerce in 1968. In 1970, Congress passed legislation prohibiting companies like Arkansas Best from acquiring nonbanking businesses. As a result, the taxpayer attempted to sell its bank stock. This proved difficult because the bank had a weak loan portfolio. To protect the taxpayer's business reputation, by not permitting the bank to go under, the taxpayer participated in preemptive rights offerings after 1970 and, in 1972, it purchased the bank president's stock to insure his noninterference with the sale and to obtain his resignation. In 1974, the taxpayer purchased bank stock held by an insurance subsidiary. By 1980, the taxpayer had sold all of its holdings in the bank at a loss, which it took as an ordinary loss. The Service disallowed the ordinary loss on the ground that the loss was capital.

Courts Split. The Eighth Circuit held that all of the losses were capital. *Corn Products*, held the court, should not be extended beyond its facts. In so doing, the court rejected the business purpose-investment purpose rule used by certain courts including the Claims Court in *Booth Newspapers*, 303 F.2d 916 (Ct. Cl., 1962) and *Dearborn Co.*, 444 F.2d 1145 (Ct. Cl., 1971), which held that capital stock acquired for business purposes is an ordinary asset, while capital stock acquired for investment purposes is a capital asset. Similarly, the Eighth Circuit rejected the substantial investment purpose test used by the Tax Court. Under that test, property is treated as an ordinary asset only if the taxpayer bought and retained the asset without a substantial investment purpose.

According to the court, *Corn Products* neither required or permitted the courts to decide that capital stock can be anything other than a capital asset under Section 1221 (except in the case of securities dealers under the provisions of Section 1236). It was up to Congress to create exceptions to Section 1221; the courts lacked the authority.

Finally, the dissent reasoned that *Corn Products* was an attempt to determine Congressional intent. Here the taxpayer was compelled to purchase the bank stock to preserve its equity in the bank and was thus purchased as an integral and necessary act in the conduct of its business. Thus the losses incurred on the sale of the stock acquired after the bank had determined to sell its holdings were ordinary.

While the Tax Reform Act of 1986 (when fully effective), will tax ordinary and capital gains at the same rates, capital losses will continue to be disadvantaged and the *Corn Products* doctrine will continue to be important. ♠

IS ITC RECAPTURE A "TAX" FOR PURPOSES OF ESTIMATED TAX?

Investment tax credit recaptured in the preceding year has been held not to be a "tax" for purposes of determining current estimated tax liability under a safe harbor provision. In so ruling, the Federal Circuit in *Berkshire Hathaway, Inc.*, CA-FC, 9/30/86, *aff'g* Cls. Ct., 9/30/85 affirmed the judgment of the Claims Court but split with the Sixth and Seventh Circuits on this issue.

In *Berkshire Hathaway*, a corporate taxpayer had a loss and thus no taxable income in 1975. In that same year, the taxpayer prematurely disposed of property for which investment tax credits (ITC) had been taken. The early disposition resulted in recapture of ITC and tax liability under Section 47.

In 1976, the taxpayer earned a taxable income and incurred a tax liability. However, the taxpayer paid no estimated tax in 1976 on the ground that it had no tax liability in the previous year and thus was covered by the safe harbor provision of Section 6655(d).