KPMG

Negative 263A costs

Assessing the impacts of the final 263A regulations

Overview

The IRS and Treasury recently released final section 263A regulations that add significant complexity to allocating additional section 263A costs to ending inventory under the simplified methods. The IRS and Treasury modified the regulations primarily to prevent producers from including certain "negative adjustments" in the numerator of the simplified production method absorption ratio. However, the regulations also include broad new rules that define the types of direct costs that must be included in book inventory under any of the simplified methods. Thus, any taxpayer (wholesaler, distributer, producer, etc.) that uses a simplified method will be required to carefully review their book inventory costing methods to ensure that all direct costs are properly capitalized for book purposes.

The regulations will primarily affect producers that use the simplified production method (SPM) to allocate additional 263A costs to ending inventory and remove overcapitalized costs from book inventory using a negative adjustment in the numerator of the SPM absorption ratio (for example, in years that book depreciation exceeds tax depreciation). Beginning in 2019, producers (that are ineligible for the $50 million small taxpayer exception) that choose to include negative adjustments in the numerator of the simplified method absorption ratio must change to the new "modified simplified production method" (MSPM) provided in the final regulations. The MSPM is essentially the SPM split into a preproduction ratio and a production ratio. For taxpayers that incur most of their additional 263A costs during the production phase, the MSPM may provide a more favorable result than the traditional SPM as fewer costs will be allocated to slower-turning raw materials inventory.

The final regulations may also impact a taxpayer that uses the traditional SPM or the simplified resale method (such as wholesalers, distributors, and retailers) if the taxpayer does not capitalize a sufficient amount of direct costs under the taxpayer's book inventory costing method. Under the de minimis rules and safe harbor provisions, a taxpayer must capitalize at least 95 percent of direct costs under its book methodology. If any of these tests are not met, the taxpayer will be required to make complex adjustments to their book inventory costing methods.

The final regulations are effective for taxable years that begin on or after November 19, 2018. Thus, a calendar year company that wants to continue including negative adjustments in the SPM must switch to the MSPM for the 2019 calendar year. Revenue Procedure 2018-56 provides that changes to the MSPM are eligible for the automatic consent procedures for taxable years ending on or after November 20, 2019 and waives the five-year eligibility restriction for three years (meaning if a taxpayer filed a change under section 263A in the past five years it may file another change to the methods in the final regulations under the automatic consent procedure). The IRS National Office has clarified that taxpayers have the option to apply the final regulations one year early to the year prior to the date they become mandatory (2018 for a calendar year taxpayer) by filing changes under the automatic consent procedures.

How KPMG can help

KPMG's business tax services

KPMG offers dedicated local and national resources with extensive experience in assisting companies with the application of section 263A. KPMG can assist in evaluating the impacts of the final 263A regulations on a taxpayer's current methodology and implementing any necessary changes in process. In addition, KPMG can assist with the preparation and review of any necessary Form 3115s required as a result of changes required under the final 263A regulations.

Furthermore, the IRS and Treasury recently issued proposed regulations to clarify the treatment of depreciation, amortization, or depletion allocated to and capitalized to inventory property under section 263A and included in cost of goods sold for purposes of determining the deduction for interest expense under 163(j). KPMG can assist with simultaneously reviewing a company's 263A methodology for changes required under the final 263A regulations as well as determine whether an accounting method change is necessary in order to determine depreciation allocable to COGS for purposes of the proposed 163(j) regulations.

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