Internal Revenue Service

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Department of the Treasury

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Date: September 18, 2001

Subject: Request Concerning Method of Accounting for Transportation and Material Handling Costs Related to Coal and Oil Used to Produce Electricity

We sent the following letter to , EIN: , (hereinafter "the taxpayer") detailing our reasons for refusing to grant it permission to make an accounting method change.

FACTS

The Taxpayer is the parent corporation of an affiliated group that files a consolidated income tax return on a calendar year basis. The Taxpayer is an electric utility in the business of generation, transmission, distribution, and sale of electricity. In connection with this business, the Taxpayer utilizes coal and oil as fuel sources. No other member of the affiliated group uses these items in their businesses. Thus, the Taxpayer is seeking permission to change only its method of accounting. The Taxpayer uses an overall accrual method of accounting.

To produce electricity for sale, the Taxpayer burns coal and oil at power generation plants. The Taxpayer seeks permission to change how it accounts for the costs of transporting coal and oil between the point where title to these products is obtained and the power plant where the coal and oil will be used in the production of electricity. Modes for this transportation include rail car, barge, truck and conveyor belt. The Taxpayer also seeks permission to change how it accounts for the costs associated with the handling of the coal and oil after they are delivered to the power plant, for example, payroll taxes, and salaries and benefits paid to personnel. Alternatively, the Taxpayer requests approval for it to use a particular facts and circumstances allocation method as referenced by Treas. Reg. § 1.263A-1(f).[1]

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[1] The particular method proposed is as follows:

$$\frac{\text{inventoriable costs}}{\text{kilowatt-hours produced}} \times \text{ending inventory} = \text{costs allocated to inventory}$$

Inventoriable costs includes the cost of the coal and oil consumed and all coal and oil transportation and material handling costs incurred in the year. Kilowatt-hours produced is the actual amount of kilowatt-hours of electricity produced in the year. Ending inventory is the amount of kilowatt-hours of electricity produced in the year that have yet to be sold and remain on hand at year end.

Under the present accounting method, the Taxpayer capitalizes coal and oil transportation and material handling costs as part of the cost of the coal and oil. Thus, these costs do not enter into the Taxpayer's computation of taxable income until the tax year in which the coal and oil are actually burned to generate electricity. Because of the nature of electricity, the burning of coal and oil is almost simultaneous with the sale of the electricity produced.

Under the proposed accounting method, the Taxpayer would deduct under IRC §§ 162 and 461 coal and oil transportation and material handling costs in the tax year in which the costs are incurred. None of these costs would be capitalized.

At the time the Taxpayer filed the Form 3115, the Taxpayer was under examination for tax years through . The Form 3115 was filed with the consent of the director as specified in section 6.01(4) of Rev. Proc. 97-27, 1997-1 C.B. 680. Furthermore, the Taxpayer was before an appeals office when it filed the Form 3115. An appeals office representative agreed that the change in accounting method requested is not an issue under consideration. *See* section 6.02 of Rev. Proc. 97-27.

DENIAL OF CONSENT

The cost of transporting coal and oil from the place where title is obtained to a power plant where they can be used in the production of electricity is a cost of acquisition that is properly treated as part of the cost of the coal and oil. *See generally* Rev. Rul. 72-113, 1972-1 C.B. 99; *Maier Brewing Company v. Commissioner*, T.C.M. 1987-385, *aff'd*, 916 F.2d 716 (9th Cir. 1990); *Sears Oil Co., Inc. v. Commissioner*, T.C.M. 1965-39*; D. Loveman & Son Export Corporation v. Commissioner*, 34 T.C. 776 (1960), *aff'd,* 296 F.2d 732 (6th Cir. 1961), *cert. denied*, 369 U.S. 860 (1962). Accordingly, the Taxpayer's present method of capitalizing coal and oil transportation costs is a correct method of accounting and not an incorrect method as asserted by the Taxpayer.

As part of the cost of coal and oil, these transportation costs would not enter into the computation of taxable income until the coal and oil are consumed when electricity is produced and sold. This would be the case regardless of whether the cost (including acquisition costs) of coal and oil used to produce electricity is deemed to be a direct or indirect material cost subject to IRC § 263A or materials and supplies subject to Treas. Reg. § 1.162-3.

In contrast, the cost of handling coal and oil at a power plant is not a cost of acquisition. *See* Treas. Reg. § 1.162-3. However, the Taxpayer's present method of capitalizing these costs is also a correct method of accounting under IRC § 263A. Costs associated with this coal and oil do not enter into the computation of taxable income until the coal and oil are consumed when electricity is produced and sold. Handling costs, as a cost associated with property that is held for future production, must be capitalized in accordance with the requirements of IRC § 263A.

<u>Application of IRC § 263A</u>

IRC § 263A applies to the cost of transporting and handling coal and oil used in the production of electricity for sale to customers as follows:

(1) *Producers of electricity are subject to IRC § 263A.* Generation of electricity constitutes production of tangible personal property. *See Helvey v. Wabash County REMC*, 278 N.E.2d 608 (Ind. App. 1972); *Minnesota Power & Light Company v. Taxing District*, 182 N.W.2d 685 (Minn. 1970); *Curry v. Alabama Power Co.*, 8 So.2d 521 (Ala. 1942); *State Tax Commission v. Marcus J. Lawrence Mem. Hosp.*, 495 P.2d 129 (Ariz. 1972). Thus, all direct and indirect costs attributable to the production of electricity for sale to customers are subject to capitalization in accordance with the requirements of IRC § 263A and the regulations thereunder. *See* IRC §§ 263A(a) and 263A(b)(1); Treas. Reg. § 1.263A-1(a)(3)(ii).

(2) *The cost of coal and oil becomes a cost of electricity produced when the coal and oil are consumed in the ordinary course of production.* Treas. Reg. § 1.263A-1(e)(2)(i)(A) provides that producers must capitalize direct material costs, which include the cost of those materials that become an integral part of specific property produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced. Arguably, coal and oil used to produce electricity constitute direct material costs because they are consumed in the production of electricity and can be directly associated with particular units of property produced (that is, there is a direct connection between tons of coal and gallons of oil consumed and kilowatt-hours of electricity thereby produced). However, even if the cost of coal and oil were deemed to not qualify as a direct material cost under Treas. Reg. § 1.263A-1(e)(2)(i)(A), coal and oil would still be subject to IRC § 263A as indirect material costs. Treas. Reg. § 1.263A-1(e)(3)(i) provides that taxpayers subject to IRC § 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale, including indirect material costs (which include the cost of materials that are not an integral part of specific property produced and the cost of materials consumed in the ordinary course of performing production or resale activities that cannot be identified or associated with particular units or groups of units of property). Note: A cost described in Treas. Reg. § 1.162-3, relating to the cost of a material or supply, specifically is listed as an indirect material cost for purposes of IRC § 263A.

(3) *IRC § 263A requires capitalization of coal and oil transportation and handling costs.* IRC § 263A requires accumulation of costs associated with the production of property until those costs can be attributed to property produced and matched with income from the sale of that property. *See* Preamble to § 263A; S. Rep. No. 313, 99th Cong., 2d Sess. 140 (1986). Coal and oil transportation costs (that is, those costs not already accounted for as an acquisition cost that is part of the cost of coal and oil) and material handling costs must be accumulated until the Taxpayer is able to allocate those costs as a cost of the electricity produced when the associated coal and oil are consumed. Accumulating coal and oil transportation and material handling costs until the coal and oil is consumed is consistent with the rule for pre-production costs that appears in Treas. Reg. § 1.263A-2(a)(3)(ii), which provides that if property is held for future production, taxpayers must capitalize direct and indirect

> costs allocable to that property (for example, purchasing, storage, handling, and other costs), even though production has not begun.

Application of Treas. Reg. § 1.162-3

The cost of transporting coal and oil from the place where title is obtained to a power plant where they can be used in the production of electricity cannot be deducted until the coal and oil are consumed even if coal and oil are deemed to be materials and supplies subject to Treas. Reg. § 1.162-3. Treas. Reg. § 1.162-3 provides that taxpayers carrying materials and supplies on hand should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year for which the return is made. These charges include acquisition (transportation) costs.

Conclusion

Coal and oil transportation and material handling costs are subject to capitalization requirements and cannot be deducted until the associated coal and oil are consumed and electricity is produced. Treas. Reg. § 1.446-1(a)(2) provides that no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. *See also* IRC § 446(b). IRC § 446(e) and Treas. Reg. § 1.446-1(e)(2)(i) provide that a taxpayer must secure consent of the Commissioner before changing a method of accounting. In order to clearly reflect income, the Taxpayer must continue to capitalize coal and oil transportation and material handling costs and not include those costs in the computation of taxable income until the associated coal and oil are consumed in the actual production of electricity. Accordingly, permission to change to the proposed method of accounting for coal and oil transportation and material handling costs, which would not clearly reflect income, is denied. Similarly, permission for the Taxpayer to change to its alternative facts and circumstances allocation method is denied. The alternative method would not clearly reflect income because it improperly accelerates the deduction of coal and oil transportation and material handling costs that are associated with electricity that will not be produced until a subsequent tax year.

This letter is directed only to the Taxpayer and may not be used or cited as precedent.

Sincerely,
Office of Associate Chief Counsel
Income Tax and Accounting
Thomas A. Luxner
Chief, Branch 6

cc: