Internal Revenue Service

Department of the Treasury

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Refer Reply To:
CC:ITA:B6/CAM-120855-98
Date: September 25, 2001

Subject: Request Concerning Method of Accounting for Material Handling Costs Related to Coal Used to Produce Electric Energy

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. The taxpayer had filed a Form 3115, Application for Change in Accounting Method, on behalf of its subsidiary, EIN: , (hereinafter "the Subsidiary"). This Form 3115 requested permission to change the Subsidiary's method of accounting for certain coal handling costs for the tax year beginning

FACTS

The Taxpayer is the parent corporation of an affiliated group filing consolidated income tax returns on a calendar year basis. One of the Taxpayer's subsidiaries, the Subsidiary, is engaged in the production, transmission, distribution and sale of electric energy. In connection with these activities, the Subsidiary uses coal as a fuel source. No other member of the Taxpayer's affiliated group uses coal in this manner in their trades or businesses. Thus, the Form 3115 was filed solely to obtain permission to change the Subsidiary's method of accounting.

To produce electric energy for sale, the Subsidiary burns coal at power generating plants. The Taxpayer seeks permission to change how the Subsidiary accounts for the costs of handling the coal once title to the coal is obtained, which ordinarily is at the mine itself. Examples of these costs include transporting, hauling, storage, insurance, sales tax, depreciation, utilities, cleaning supplies and handling. Alternatively, the Taxpayer requests approval for the Subsidiary 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 consumed and all coal handling costs

Under the present accounting method, the Subsidiary capitalizes coal handling costs as part of the cost of the coal. Thus, these costs do not enter into the Subsidiary’s computation of taxable income until the tax year in which the coal is actually burned to generate electric energy. Because of the nature of this energy, the burning of coal is almost simultaneous with the sale of the electric energy produced.

Under the proposed accounting method, the Subsidiary would deduct under IRC §§ 162 and 461 coal 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. The Taxpayer was also before an appeals office for tax years through . The appeals office has agreed with the Taxpayer that the issue under consideration by that office is not the same method of accounting the Taxpayer is requesting to change. Section 6.02 of Rev. Proc. 97-27.

DENIAL OF CONSENT

The cost of transporting coal from the place where title is obtained to a power plant where it can be used in the production of electric energy is a cost of acquisition that is properly treated as part of the cost of the coal. *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 Subsidiary’s present method of capitalizing coal 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, these transportation costs would not enter into the computation of taxable income until the coal is consumed when electric energy is produced and sold. This would be the case regardless of whether the cost (including acquisition costs) of coal used to produce electric energy 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 at a power plant is not a cost of acquisition. *See* Treas. Reg. § 1.162-3. However, the Subsidiary's present method of capitalizing these costs is also a correct method of accounting under IRC § 263A. Costs

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incurred in the year. Kilowatt-hours produced is the actual amount of kilowatt-hours of electric energy produced in the year. Ending inventory is the amount of kilowatt-hours of electric energy produced in the year that have yet to be sold and remain on hand at year end.

associated with this coal do not enter into the computation of taxable income until the coal is consumed when electric energy 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.

Application of IRC § 263A

IRC § 263A applies to the cost of handling coal, including transportation, used in the production of electric energy for sale to customers as follows:

(1) *Producers of electric energy are subject to IRC § 263A.* Generation of electric energy 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 electric energy 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 becomes a cost of electric energy produced when the coal is 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 used to produce electric energy constitutes a direct material cost because it is consumed in the production of electric energy and can be directly associated with particular units of property produced (that is, there is a direct connection between tons of coal consumed and kilowatt-hours of electric energy thereby produced). However, even if the cost of coal was deemed to not qualify as a direct material cost under Treas. Reg. § 1.263A-1(e)(2)(i)(A), coal would still be subject to IRC § 263A as an indirect material cost. 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 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, 99^{th} Cong., 2d Sess. 140 (1986). Coal transportation costs (that is, those costs not already accounted for as an acquisition cost that is part of the cost of coal) and material handling costs must be accumulated until the Subsidiary is able to allocate those costs as a cost of the electric energy produced when the associated coal is consumed. Accumulating coal transportation and material handling costs until the coal 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 from the place where title is obtained to a power plant where it can be used in the production of electric energy cannot be deducted until the coal is consumed even if coal is 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 tax year for which the return is made. These charges include acquisition (transportation) costs.

Conclusion

Coal handling costs are subject to capitalization requirements and cannot be deducted until the associated coal is consumed and electric energy 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 Subsidiary must continue to capitalize coal handling costs and not include those costs in the computation of taxable income until the associated coal is consumed in the actual production of electric energy. Accordingly, permission to change to the proposed method of accounting for coal handling costs, which would not clearly reflect income, is denied. Similarly, permission for the Subsidiary to change to the proposed alternative facts and circumstances allocation method is denied. The alternative method would not clearly reflect income because it improperly accelerates the deduction of coal handling costs that are associated with electric energy 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: