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Department of the Treasury

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CC:ITA:B6/CAM-100872-99

Date:

September 24, 2001

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

We sent the following letter to ██████████, EIN: ██████████, (hereinafter "the Taxpayer") detailing our reasons for denying permission for its subsidiary, ██████████, EIN: ██████████, (hereinafter "the Subsidiary"), to make a requested change in accounting method. The Taxpayer had filed a Form 3115, Application for Change in Accounting Method, on behalf of the Subsidiary) seeking permission to change the Subsidiary's method of accounting for certain coal transportation and material 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. The Taxpayer and all of its subsidiaries use an overall accrual method of accounting.

The Taxpayer has filed a Form 3115 to obtain permission to change the accounting method for certain coal transportation and material handling costs incurred by the Subsidiary. The Subsidiary is a public utility in the trade or business of producing and selling electricity to the general public. No change in accounting method has been requested regarding the Taxpayer or its other subsidiaries.

To produce electricity for sale, the Subsidiary burns coal at power generating plants. The Taxpayer seeks permission to change how the Subsidiary accounts for the costs of transporting coal between the point where title to the coal is obtained, which ordinarily is at the mine itself, and the power plant where the coal will be used in the production of electricity. This transportation may be via rail car, barge, truck or conveyor belt. The Taxpayer also seeks permission to change how the Subsidiary accounts for the costs associated with the handling of the coal after it is delivered to the power plant, for example, payroll taxes and salaries and benefits paid to personnel handling the coal once it is at the plant site. 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).<sup>1</sup>

Under the present accounting method, the Subsidiary capitalizes coal transportation and material 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 electricity. Because of the nature of electricity, the burning of coal is almost simultaneous with the sale of the electricity produced.

Under the proposed accounting method, the Subsidiary would deduct under IRC § 162 coal 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. 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.

#### 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 electricity 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 (9<sup>th</sup> 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 (6<sup>th</sup> 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 electricity is produced and sold. This would be the case regardless of whether the cost (including acquisition

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<sup>1</sup> 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 transportation and 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.

costs) of coal 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 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 associated with this coal do not enter into the computation of taxable income until the coal is 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.

#### Application of IRC § 263A

IRC § 263A applies to the cost of transporting and handling coal 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 becomes a cost of electricity 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 electricity constitutes a direct material cost because it is 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 consumed and kilowatt-hours of electricity 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 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, 99<sup>th</sup> 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 electricity 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 electricity 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 taxable year for which the return is made. These charges include acquisition (transportation) costs.

#### Conclusion

Coal transportation and material handling costs are subject to capitalization requirements and cannot be deducted until the associated coal is 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 Subsidiary must continue to capitalize coal transportation and material handling costs and not include those costs in the computation of taxable income until the associated coal is consumed in the actual production of electricity. Accordingly, permission to change to the proposed method of accounting for coal transportation and material 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 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  
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