Industry Reaction to New Capitalization Rules: An Empirical Study

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Abstract

According to the new Internal Revenue Code Section 263-A, businesses with sales of more than $10 million are now required to capitalize more cost into inventory than ever before. This paper analyzes the implementation of the new requirements and then presents the results of a survey of 100 of the largest industrial firms concerning the new procedures.

Introduction

The Tax Reform Act of 1986 ("TRA 1986", also referred to as the Internal Revenue Code of 1986) has become a never-ending nightmare for many industrial corporations. Confusion about such matters as income tax credits, alternative minimum tax, and the new inventory accounting rules are baffling businesses throughout the United States. According to the new Code Section 263-A, businesses with sales of more than $10 million are now required to capitalize more costs into inventory than ever before, therefore decreasing deductions and increasing taxable income and taxes payable to the government.

The objective of this paper is to analyze the effect of these changes and to review the reaction of businessmen to the new capitalization rules of the TRA 1986.

Overview of the Old & New Inventory Accounting Rules

Manufacturing, Construction, Etc. Involving Production of Real or Personal Property

Under the old rules, the Treasury Regulations require that all direct and indirect production costs be included in inventory and not be used to reduce taxable income until the goods are sold (see *The Tax Reform Act of 1986*, p. 134). The determination of which direct and indirect costs constitute production costs was made in accordance with the full-absorption method. Under the new rules, indirect production costs are classified into three categories under the full-absorption method. Category 1 costs must be included in inventory costs. These costs include repair expenses, maintenance, utilities, rent, indirect labor and production supervisory wages, and other similar costs. Category 2 costs are not required to be included in inventory costs. These costs include such items as marketing expenses, advertising expenses, selling expenses, warehousing costs, etc. Category 3 costs are to be included in inventory costs only if the costs are included in inventory for purposes of the taxpayer's financial reports. Category 3 consists of costs such as depreciation reported on financial statements, cost depletion on assets incident to and necessary for the production or manufacturing processes, factory administrative expenses, insurance costs incident to and necessary for production or manufacturing operations, and are costs attributable to rework labor, scrap, spoilage, and strike (see *The Tax Reform Act of 1986*, pp. 134-135).

Some indirect costs, which were previously allowed as period costs, will be disallowed and must be included in inventory. Companies will potentially be adding more to inventory than that which they added previously under generally accepted accounting principles. A comparison of the indirect cost categories between the old and the new law is shown in Table 1.

Long-Term Contracts

Some direct and indirect costs are now to be included in contract costs for long-term contracts instead of being deducted in the period in which they are paid. The Act attempts to create a single set of rules for taxpayers to follow, thereby avoiding any deduction of costs which should be capitalized and avoiding the use of various capitalization rules.

All long-term contract costs are now subject to the

Table 1: Indirect Costs: Old Law vs. New Law

Indirect Cost	Category Old Law	Category New Law
Excess of accelerated tax depreciation and amortization over financial statement depreciation and amortization	2	1
Warehousing costs	2	1
Interest(*)	2	1
Other general and administrative costs incident to taxpayer's activities as a whole	2	1
General and administrative costs incident and necessary to production or operations	3	1
Factory general and administrative costs incident and necessary to production or operations	3	1
Taxes (except income taxes)	3	1
Officer salaries incident to production or operations	3	1
Insurance attributable to production or operations	3	1
Strikes, rework labor, scrap, spoilage incident to production or operations	3	1
Current pension contributions	3	1
Current fringe benefit contributions	3	1

Legend for cost categorization:
1=Cost must be included in inventory
2=Cost not required to be included inventory
3=Cost must follow treatment on financial statements if prepared in accordance with costs ordinarily included in inventory under generally accepted accounting principles

*Only for the construction or manufacture of real estate, property costing more than $1 million and requiring more than one year to construct, and property requiring two or more years to construct or manufacture. Does not apply to real estate or personal property acquired for resale (see Price Waterhouse Guide, 1986, p. 193).

same capitalization rules which are presently being used under the extended contract method. Exceptions to this general rule concern contracts which (1) are expected to be completed within the two-year period beginning on the commencement date of the contract, and (2) are performed by taxpayers whose annual gross receipts for the three taxable years preceding the taxable year in which the contract is entered into does not exceed $10 million.

Survey of Executive Opinion

Regardless of the intent of Congress, American businessmen are the ones who must comply with the new tax law's inventory requirements. The researchers conducted a survey to gain insight into the attitudes and opinions held by businessmen who are affected by the uniform capitalization rules. One hundred companies were randomly selected for the survey from Fortune's 1986 listing of the 500 largest industrial corporations. In the spring of 1987, questionnaires (available upon request) were mailed to each company's senior financial officer and forty-three usable responses were received. Questions were restricted to the cost and application of the uniform capitalization rules.

Nineteen of the forty-three respondents (44.2 percent) reported a clear understanding of the new guidelines of the capitalization rules. Table 2 provides a breakdown of their responses. What is noteworthy is the significant number of businessmen who are unclear about the new guidelines. A majority (56 percent) of the respondents are unsure of the new guidelines. This uncertainty could lead to inconsistencies in the application of the new capitalization rules from business to business.

Table 2: Are the new IRS guidelines concerning inventory accounting rules clear for your corporation? (43 Respondents)

Answer	Response Percentage
Yes	44.2%
No	41.9%
Uncertain	13.9%

In anticipation of such uncertainty problems, the executives were questioned on the anticipated extra man hours a company will have to invest in order to comply with the TRA 1986 capitalization rules. Their responses are presented in Table 3. Based on these responses, over half (53.6 percent) of the respondents expect to spend over 500 man hours to meet the minimum requirements of the new inventory rules.

Table 3: How many extra manhours do you estimate will be required to comply with the new inventory accounting rules? (43 Respondents)

Between 0 and 500 hours	29.9%
Between 501 and 1000 hours	30.3%
Over 1000 hours	23.3%
An estimate is not presently available	16.5%

Since time is money, it was appropriate to ask what the companies' anticipated cost of such man hours would be? These results are shown in Table 4. Although over one-third of the respondents were unable to estimate the cost of additional man hours, 27.9 percent anticipate costs to exceed $200,000. This cost, in addition to the higher tax bill for the business, makes this provision in the Tax Reform Act of 1986 extremely costly for business. With American businesses suffering at the hands of foreign competition, questions are being raised as to whom Congress is actually trying to help by these new rules: U.S.A. or foreign suppliers.

Table 4: What do you estimate will be the total marginal cost of complying with these rules? (43 Respondents)

Between $0 - $10,000	7.0%
Between $10,001 - $50,000	18.6%
Between $50,001 - $100,000	9.3%
Between $100,001 - $200,000	2.3%
Over $200,000	27.9%
An estimate is not presently available	34.9%

Several cross tabulations were analyzed to determine if any significant relationships existed between responses to the questions. The responses to questions 2 (Table 3) and 3 (Table 4) were analyzed and it was found that a statistically significant relationship existed between the number of extra man hours required to comply with the new inventory rules and the marginal cost of complying with the rules. The fewer the man hours the less the marginal cost and vice versa. The relation was significant with a p-value of 0.0129 using Fisher's Exact Probability Test.

With the loss of the deductibility of some indirect costs, the next question addressed the firms' policy concerning the reduction of their production level in an effort to reduce and keep inventory to a minimum. The answer was that no change in production was anticipated as a result of the new tax rules. As shown in Table 5, 81.0 percent of the respondents will not alter their production process because of the capitalization rule.

Table 5: Will these rules affect your production process to reduce inventory levels? (42 Respondents)

Answer	Response Percentage
Yes	7.2%
No	81.0%
Uncertain	11.8%

In essence, U.S. firms could be penalized because of these additional costs cannot be passed on to the consumer because foreign competitors are not affected by this additional tax and can thereby undercut American manufacturers in price.

The conference report provides examples in which the cost of buyers, warehousing, and allocable general and administrative expenses are allocated to inventory. As Table 6 indicates, twenty-two of the forty respondents (55 percent of those who responded to this question) feel that the examples were insufficient.

Table 6: The cost of buyers, warehousing, and allocable general and administrative expenses will now be required to be included in the cost of inventory for some retailers and wholesalers. Do you feel that the conference report provides adequate examples? (40 Respondents)

Yes	12.5%
No	55.0%
Uncertain	32.5%

Retailers and wholesalers with annual gross receipts of more than $10 million may use either the simplified or the regular method of applying the uniform capitalization rules. The simplified method has four general categories of indirect costs which are allocated to inventory: (1) Off-site storage and warehousing costs; (2) Purchasing costs; (3) Handling, processing, assembly, and repackaging costs; and (4) Any general and administrative costs which benefit the other three categories (see Price Waterhouse Guide, 1986, p. 195). The regular method requires that all costs incurred in manufacturing or constructing property or in purchasing and holding property for resale will be included in inventory (see The Tax Reform Act of 1986, p. 142). Once a method is chosen, it must be applied consistently from year to year. The respondents are evenly divided between the two methods as shown in Table 7.

Table 7: Will your corporation choose the simplified method of applying the uniform capitalization rules or the regular method? (42 Respondents)

Simple Method	Regular Method	Uncertain
35.8%	35.8%	28.4%

A significant relationship was found in the responses to questions 1 and 6. The firms that indicated that the new IRS guidelines were clear tended to agree that the examples of compliance in the conference report were adequate. And, inversely, the firms indicating that the new guidelines were not clear reported that the examples were not adequate to a much less degree than normally expected. The relationship was tested with chi-square and resulted in a significant association at the one percent level of significance.

One respondent commented that "current plans were made to use the regular method for production service activities and the simplified service cost method for mixed service activities, such as general, administrative, research, and development expenses." Other firms may also find this procedure beneficial.

As illustrated in Table 8, many corporations have or will establish two separate accounting systems--one to determine inventory values under GAAP and another to conform with the new law.

Table 8: Will your corporation establish two accounting systems--one system to determine the inventory values under GAAP, and a second to comply with the tax law? (43 Repondents)

Yes	No	Uncertain
53.5%	32.6%	13.9%

In the tax legislation process, there are generally multiple objectives which must be considered. However, in this instance, the underlying goal of the lawmakers was to increase taxable income and taxes. The anticipated internal cost of compliance to those new rules has many corporations wondering if the same effect could not be generated by simply imposing an additional tax on the corporations, thus alleviating substantial internal cost and an additional administrative burden on American corporations.

The new capitalization rules are inconsistent since the new rules are patterned after existing regulations with respect to extended-period, long-term contracts under IRS Section 451. Conceptually, accounting considerations applicable to long-term contracts are not necessarily applicable to generally accepted accounting principles with respect to inventory valuation. Timing considerations and resulting cash flows applicable to inventories have little in common with long-term contract considerations. Nevertheless, Congress did not consider this distinction and has attempted to force taxpayers to capitalize as many different types of costs as possible. It is one thing to require the capitalization of certain types of overhead costs such as general and administrative expenses, in which a portion of such expenses could be expensed or capitalized without much theoretical objection. However, it is a completely different matter to force corporate taxpayers to capitalize gross receipts taxes, franchise taxes, royalties (based on sales), percentage depletion, and other costs which have no relation to the production cycle or the ending inventory position.

The requirement that percentage depletion be treated as an inventoriable cost is not only untenable from a theoretical standpoint, but is in conflict with IRS Section 613. The computation of percentage depletion under current authorities (e.g. regulations, statute and case law) requires that depletion be computed based on either (1) a percentage of gross income or (2) 50 percent of net income before depletion. In either instance, the allowance for depletion is computed based on the number of mineral units sold (not produced). Therefore, the basic requirements of extended-period, long-term contracts attributable to indirect costs cannot apply since the allowance for percentage depletion does not directly benefit the ending inventory nor has it been incurred by reason of producing these particular mineral units. Thus, it seems improper to allocate a portion of the allowance to ending inventory. Secondly, and more significant from a legal standpoint, is the fact that the 1986 Act and the Committee Report issued thereunder clearly indicate that it was not the intent of Congress to change existing depletion law (see *The Tax Reform Act of 1986*, p. 232). Therefore, a significant issue arises concerning whether current depletion concepts under Section 613 can be overridden by proposed changes in inventory treatment without benefit of specific statutory authority.

In addition, natural resource companies' inventoriable costs have been solely governed by the provisions of Treasury Regulation 1.471-11 (relating to full-absorption costing). These rules were issued in the mid-1970's to force taxpayers to conform their inventory costs systems more closely with those used for financial reporting purposes. This objective has been accomplished since present systems are in accordance with GAAP. Therefore, additional overhead costs should not be allocated to inventory. Manufacturing, processing, and industrial businesses, which are in conformity with Treasury Regulation 1.471-11 and GAAP, have no theoretical justifications for applying

the new capitalization rules.

Moreover, does the Internal Revenue Service have the capacity and manpower to audit individual corporations to verify that applicable methods were used in the allocation process? One must question Congress' motives. Some knowledgeable observers believe that Congress proposed the inventory rules in an attempt to make the law so unpalatable that it would fail and then the strategy backfired with passage.

Conclusions

Compliance with the new capitalization rules will result in a proliferation of differences between book and tax accounting treatment. This is unfortunate since recent changes in the tax law prior to the 1986 Act had sought to bring tax and financial reporting closer together with respect to basic inventory cost treatment and valuation. Congress, in its newly proposed regulations, has apparently reversed its position and has, in effect, promoted differences in treatment which will surely prove confusing to the investing public, not to mention the additional administrative burden placed upon corporate taxpayers. In view of the above, it would appear the revenue-raising measures have been more of a concern to the Treasury Department than any desire to achieve true tax reform.

References

1. *The Price Waterhouse Guide to the New Tax Law.* New York, 1986.
2. *The Tax Reform Act of 1986.* Report of the Senate Finance Committee, pp. 133-152.