Internal Revenue Service

Number: **200146009**
Release Date: 11/16/2001
UIL No. 263A.0-01

Utility Specialist

Internal Revenue Service

Department of the Treasury

1111 Constitution Avenue NW
Washington DC 20224

Person to Contact:
)
Telephone Number:
202-622-4970
Refer Reply To:
CC:ITA:B6/CAM-107709-99
Date:June 20, 2001

Subject: Parent-
EIN:
Subsidiary-
EIN:

Attached to this memorandum is the letter we have sent to on behalf of its wholly-owned subsidiary, ( ), which details our reasons for refusing to grant permission for to make an accounting method change. As explained in the letter, sought permission to change its accounting method for certain coal transportation costs.

Thomas A. Luxner
Chief, Branch 6

Enclosure:
Copy of letter

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:
(202) 622-4970

Refer Reply To:
CC:ITA:B6 CAM-107709-99

Date:
June 20, 2001

EIN

ATTN:

Assistant Controller

RE: Request Concerning Method of Accounting for Coal Transportation Costs submitted for (EIN:)

Dear :

This letter refers to a Form 3115, Application for Change in Accounting Method, filed on behalf of its wholly-owned subsidiary, ("taxpayer"). This Form 3115 requests permission to change the taxpayer's method of accounting for certain coal transportation costs for the tax year beginning January 1, 1999.

FACTS

The taxpayer is engaged in various business enterprises in and including the generation, transmission, distribution and sale of electricity. The taxpayer uses an overall accrual method of accounting and joins in the consolidated federal income tax returns filed by on a calendar year basis.

To produce electricity for sale to its retail and wholesale customers, the taxpayer burns coal at its power generation plants. The taxpayer seeks permission to change its method of accounting for the costs of transporting coal between the point where title to the coal is obtained, which ordinarily is at the mine itself, to the power plant at which the coal will be used in the production of electricity.

Under its present method, the taxpayer includes coal transportation costs as part of the cost of the coal acquired. Thus, these transportation costs do not enter into the taxpayer'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 to the sale of the electricity.

Under the proposed method, the taxpayer would deduct under IRC § 162 coal transportation costs in the tax year in which the costs are incurred. None of these transportation costs would be capitalized.

At the time filed the Form 3115, the taxpayer was under examination for tax years 1995 and 1996. The Form 3115 was filed during the 90-day window period specified in section 6.01(2) of Rev. Proc. 97-27, 1997-1 C.B. 680. The examining agent has agreed that this window period was available. Further, the taxpayer was before appeals offices for the 1989-1990 and 1993-1994 tax years. The appeals officers have agreed that the change in accounting method requested is not an issue under consideration by their offices. *See* section 6.02 of Rev. Proc. 97-27. Additionally, the taxpayer was before federal courts for the and tax years and for the tax years . The counsels for the Government have agreed that the change in accounting method requested is not an issue under consideration by the courts. *See* section 6.03 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 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 (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 transportation costs is a correct method of accounting.

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 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.

IRC § 263A applies to the cost of 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 megawatt-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) and 1.263A-1(e)(3)(ii)(E) provide 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). A cost described in Treas. Reg. § 1.162-3, relating to the cost of a material or supply, is an indirect material cost for purposes of IRC § 263A.

Similarly, even if coal were deemed to be materials and supplies subject to Treas. Reg. § 1.162-3, the charge for coal cannot be deducted until the coal is consumed. 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.

Furthermore, even if coal transportation costs are not deemed to be an acquisition cost that is part of the cost of coal, under IRC § 263A these costs must still be accumulated until they can be charged as a cost of electricity produced. 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). Treas. Reg. § 1.263A-1(g)(3) provides that indirect costs are generally allocated to intermediate cost objectives prior to allocation to property produced. Thus, coal transportation costs must be accumulated, along with the cost of coal, until the taxpayer is able to allocate those costs as a cost of the electricity produced when the associated coal is consumed. Accumulating coal transportation 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.

In conclusion, whether the costs of transporting coal used to produce electricity for sale to customers are deemed to be part of the cost of coal or an indirect cost of producing electricity, these costs 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 taxpayer must continue to capitalize coal transportation costs and not include those costs in the computation of taxable income until the associated coal is consumed in the production of electricity. Accordingly, permission to change to the proposed method of accounting for coal transportation costs, which would not clearly reflect income, is denied.

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

Sincerely yours,

Associate Chief Counsel
Income Tax and Accounting

By_______________________
Thomas A. Luxner
Chief, Branch 6