

Internal Revenue Service

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Department of the Treasury

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Washington DC 20224**

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CC:ITA:B6/CAM-100285-99

Date:

August 14, 2001

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

Attached to this memorandum is the letter we have sent to
(hereinafter) on behalf of its five named
subsidiaries, which details our reasons for refusing to grant permission for the
subsidiaries to make an accounting method change. As explained in the letter,
sought permission to change the accounting method for certain coal transportation and
material handling costs.

Thomas A. Luxner
Chief, Branch 6

Enclosure:
Copy of letter

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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CAM-100285-99

ATTN:

Date:

August 14, 2001

RE: Request Concerning Method of Accounting for Transportation and Material Handling Costs Related to Coal submitted by
(EIN:) on behalf of Five of its Subsidiaries

Dear :

This letter refers to a Form 3115, Application for Change in Accounting Method, (hereinafter "the Taxpayer") filed on behalf of the five subsidiaries listed in Attachment A (hereinafter "the Subsidiaries"). This Form 3115 requests permission to change the Subsidiaries' method of accounting for certain coal transportation and material handling costs for the tax year beginning January 1, 1998.

FACTS

The Taxpayer is the parent corporation of an affiliated group filing consolidated income tax returns on a calendar year basis. In addition to the Taxpayer, the affiliated group consists of corporations. 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 Subsidiaries. The Subsidiaries are public utilities in the trade or business of generation, transmission, distribution and sale of electricity. No change in accounting method has been requested regarding the Taxpayer or its other subsidiaries.

To produce electricity for sale, the Subsidiaries burn coal at power generation plants. The Taxpayer seeks permission to change how the Subsidiaries account 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 Subsidiaries account for the costs associated with the handling of the coal after it is delivered to the power plant, for example, salaries, payroll taxes and benefits paid to personnel. Alternatively, the Taxpayer requests approval for the Subsidiaries to use a particular facts and circumstances allocation method as referenced by Treas. Reg. § 1.263A-1(f).¹

Under the present accounting method, the Subsidiaries capitalize coal transportation and material handling costs as part of the cost of the coal. Thus, these costs do not enter into the Subsidiaries' 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 Subsidiaries 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 for tax years _____ . 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 a federal court for year(s) prior to calendar year _____. The Government's counsel agreed that the change in accounting method requested is not an issue under consideration by the court. 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 Subsidiaries' present

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 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.

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 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 Subsidiaries' 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, 99th 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 Subsidiaries are 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 Subsidiaries 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 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 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 yours,

Associate Chief Counsel
Income Tax and Accounting

By _____
Thomas A. Luxner
Chief, Branch 6

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cc:

ATTN:

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Change in Method Issue Specialist

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Attachment A

1. EIN:
2. EIN:
3. EIN:
4. EIN:
5. EIN: