DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

November 2, 2001

Number: **200206012**
Release Date: 2/8/2002
CC:ITA
TL-N-2586-01
UILC: 263A.06-02

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, LMSB, DETROIT
(CC:LM:MCT:DET)

FROM: Associate Chief Counsel (Income Tax & Accounting)(CC:ITA)

SUBJECT: 3-Year Average Revaluation Method

This Chief Counsel Advice responds to your memorandum dated August 8, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =

ISSUES

1. Whether a taxpayer that uses the dollar-value last-in, first-out (LIFO) method in connection with the retail method is entitled to use the 3-year average method

provided by Treas. Reg. § 1.263A-7(c)(2)(v) to compute a § 481(a) adjustment when it changes its method of computing its cost complements under § 1.471-8.

2. Whether the 3-year average method described in Treas. Reg. § 1.263A-7(c)(2)(v) is a method of accounting for purposes of § 446.

3. If the 3 year-average method is a method of accounting, under the circumstances described below, does its use clearly reflect the taxpayer's income when it values some of the taxpayer's LIFO layers below cost?

4. Whether the Commissioner may challenge the taxpayer's method of revaluing its inventory when the taxpayer revalues its inventory using a method that is specifically provided by the regulations.

CONCLUSIONS

1. A taxpayer that uses the dollar-value LIFO method in connection with the retail method to value its inventories is not entitled to use the 3-year average method to compute its § 481(a) adjustment when it changes its method of computing its cost complements. The 3-year average method is a method for computing a § 481(a) adjustment when a taxpayer changes its method of accounting for costs subject to § 263A. A change in method of accounting for costs subject to § 263A does not include a change in method of computing cost complements under § 1.471-8.

2., 3., and 4. Since the answer to issue one is no, the remaining issues are moot and will not be addressed.

FACTS

Taxpayer is engaged in the purchase and sale of consumer goods through retail stores and uses the dollar-value LIFO method in connection with the retail method to value its inventories. Taxpayer also uses department store indexes prepared by the United States Bureau of Labor Statistics ("BLS") pursuant to Treas. Reg. § 1.472-1(k) and Rev. Proc. 72-21, 1972-1 C.B. 745 (superceded by Rev. Proc. 86-46, 1986-2 C.B. 739).

Taxpayer's use of the retail method may be described as follows. First, Taxpayer determines the selling value of its beginning and ending inventory on a pool-by-pool basis. Next, Taxpayer reduces the ending and beginning inventory of each pool to base year selling value by applying Department Store BLS indexes. Then, Taxpayer compares its ending inventory stated at base year selling value to its beginning inventory stated at base year selling value to determine whether the value of its inventory has increased or decreased. If Taxpayer determines that the value of the pool stated at base year selling value has increased, it multiplies the amount of the increase (increment) by the same BLS index to value the increment at current year selling value. Finally, the increment at current year selling value is multiplied by a ratio called the cost complement to value the increment at approximate cost. Generally, the cost complement ratio compares the cost of the goods in the beginning inventory and purchased during the year to the retail selling value of the goods in beginning inventory and purchased during the year.

When it first elected the dollar-value retail method, Taxpayer adjusted the retail sales price of its ending inventory by all the markups and markdowns that were reflected on the sales tag of the items in its ending inventory. Moreover, Taxpayer included these markups and markdowns in the denominator of its cost complements.

Sometime between Year 1 and Year 5, Taxpayer changed its method of accounting and stopped determining the retail value of its ending inventory by recording the price marked on each item's sales tag. This change was made without the Commissioner's consent. Instead, Taxpayer began determining the retail sales value of its ending inventory by using the "Regular Selling Value" of each item. The "Regular Selling Value" of an item reflected certain permanent markdowns that were made to the retail selling price, but did not reflect certain other promotional markdowns that were marked on the item's sales tag. Moreover, although the retail value of Taxpayer's ending inventory no longer reflected adjustments for promotional markdowns, Taxpayer continued to include these promotional markdowns in the retail selling value of its cost complements. Thus, under its new method of accounting, Taxpayer determined the retail value of its ending inventory using the "Regular Selling Value" of each item, which did not include promotional markdowns, but continued to include promotional markdowns in the retail selling value of its cost complements.

Under the retail method, a taxpayer, that is a retail merchant, may approximate the cost of its ending inventory by multiplying its ending inventory stated at retail selling price by the cost complement. However, the retail method does not accurately approximate cost when the factors that are included in determining the retail selling value of the ending inventory are not the same as those that are included in the retail selling value of the cost complement ratio. For example, if a taxpayer does not take markdowns into account when determining the retail value of its ending inventory, then these same markdowns should not be taken into account in the retail value of the cost complement ratio. When promotional markdowns are reflected as an adjustment to the retail selling price in the denominator of the cost complement, but are not reflected in the retail selling value of a taxpayer's ending inventory, the retail method may overstate the actual cost of the taxpayer's ending inventory. This result is demonstrated with the following example.

Assume that Retailer sells only one item, widgets, and that at the end of the year its ending inventory consists of 10 widgets with a cost of $60 per widget. Thus, the actual cost of Retailer's ending inventory is $600 ($60 * 10). Further assume that the regular list selling price (without markdowns) of a widget is $100, but with a $10 markdown the sales price is $90. Thus, Retailer's cost complement for widgets if computed using the regular list selling price would be equal to 60% ($60/$100). In contrast, the Retailer's cost complement for widgets would be 67% ($60/$90) if computed using the selling price reduced for markdowns.

If Retailer were to multiply its ending inventory valued at retail selling prices without markdowns ($1,000) by the cost complement that does not take markdowns into account (60%) it computes the correct actual cost of its ending inventory, $600. However, when the taxpayer's ending inventory is valued at retail selling prices without markdowns but is multiplied by a cost complement that takes markdowns into account (67%) the retail method overstates the actual cost of the ending inventory ($1,000 * 67%= $670).

Thus, in applying the retail method a taxpayer must eliminate from the cost complement, the promotional markdowns that are not reflected in the retail value of its ending inventory. See Rev. Rul. 79-115, 1979-1 C.B. 185.

Subsequent to making its change in accounting method, Taxpayer recognized that it was using an unauthorized and improper method of accounting and, therefore, filed a Form 3115, Application For Change in Method, for its taxable year beginning Date 1. In its Form 3115, Taxpayer proposed to change its method of calculating its cost complements. Under its proposed method, Taxpayer would not include promotional markdowns that were not reflected in the "Regular Selling Value" in the denominator of its cost complements. Moreover, Taxpayer's Form 3115 indicated that it would effectuate its change and comply with the requirements of § 481(a) by revaluing its beginning inventory for the year of change as if it had used the proposed method in prior years. Taxpayer's Form 3115 further disclosed that "In re-valuing inventories under the Proposed Method, the taxpayer determined the average point difference in cost complements under the Current and Proposed Methods of accounting for the preceding three years. For inventories valued under the LIFO method . . . the average percentage point difference was used to re-value the existing LIFO layers."

On Date 2, the National Office sent Taxpayer a letter that requested additional information concerning Taxpayer's proposed change in accounting method. The letter also requested additional information concerning the amount of Taxpayer's § 481(a) adjustment and the method Taxpayer used to compute the adjustment. With regard to Taxpayer's proposed method of computing the § 481(a) adjustment, the letter stated that "the § 481(a) adjustments should be computed by revaluing all existing LIFO layers as of the beginning of the year of change. See § 1.263A-7(c)(2)."

On Date 3, Taxpayer responded, by letter, to the National Office's request for additional information. Taxpayer's letter provided the amount of the § 481(a) adjustment and also stated that "For goods included within the scope of the proposed change in method that are accounted for using the retail LIFO inventory method the § 481(a) adjustment was calculated by reducing all inventory layers for each LIFO pool using the 3-year average technique provided in the example to Treas. Reg. § 1.263A-7(c)(2)(v)(C)."

On Date 4, the National Office issued a letter ruling to Taxpayer, which granted it permission to change its method of accounting from its present method to its proposed method, beginning with the year of change, provided that, among other things, it "took one-fourth of its proposed § 481(a) adjustment in account in computing taxable income each taxable year of the adjustment period, beginning with the year of change." However, the letter ruling did not discuss or express any opinion regarding Taxpayer's proposed method of computing its § 481(a) adjustment. Instead, the letter ruling stated that "The district director will ascertain whether . . . the amount of the § 481(a) adjustment was properly determined." Moreover, the letter ruling provided that if Taxpayer agreed to the terms and conditions set forth in the letter, an individual with the authority to bind it must sign and date a copy of the letter and return it within 45 days. Taxpayer signed and returned a copy of the letter on Date 5.

LAW AND ANALYSIS

Section 471 provides that whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade and business and as most clearly reflecting income.

Section 1.471-2(e) of the Income Tax Regulations provides, in part, that the inventories of taxpayers on whatever basis taken will be subject to investigation by the district director, and the taxpayer must satisfy the district director of the correctness of the prices adopted.

Section 1.471-8(a) provides, in part, that under the retail method the total of the retail selling prices of the goods on hand at the end of the year in each department or of each class of goods is reduced to approximate cost by deducting therefrom an amount which bears the same ratio to such total as:

> (1) The total of the retail selling prices of the goods included in the opening inventory plus the retail selling prices of the goods purchased during the year, with proper adjustment to such selling prices for all markups and markdowns, less
>
> (2) The cost of the goods included in the opening inventory plus the cost of the goods purchased during the year, bears to (1).

The result should represent as accurately as may be the amounts added to the cost price of the goods to cover selling and other expenses of doing business and for the margin of profit.

Section 1.471-8(e) provides, in part, that in no event shall markdowns not based on actual reduction of retail sales prices be recognized in determining the retail selling prices of the goods on hand at the end of the tax year.

Section 472 provides for the use of the last-in, first-out (LIFO) inventory method. Under the LIFO method, inventories on hand at the end of the year are treated as consisting first of inventory on hand at the beginning of the year and then of inventories acquired during the year. Taxpayers using the LIFO method must inventory their goods at cost.

Section 1.472-1(k) provides, in part, that if a taxpayer using the retail method of pricing inventories authorized by § 1.471-8, elects to use in connection therewith the LIFO inventory method, the apparent cost of goods on hand at the end of the year, determined pursuant to § 1.471-8, shall be adjusted to the extent of price changes therein taking place after the close of the preceding taxable year.

Section 481(a) provides that in computing the taxpayer's taxable income for any taxable year (year of change), if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding year was computed, then there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which § 481 does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

Section 1.481-1(a)(1) provides that in computing taxable income for the year of change, there shall be taken into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent amounts from being duplicated or omitted.

Section 1.263A-7(c)(1) provides that when a taxpayer changes its method of accounting for costs subject to § 263A, the taxpayer generally must, in computing its taxable income for the year of change, take into account the adjustments required by § 481(a).

Section 1.263A-7(c)(2) provides that if a taxpayer changes its method of accounting for costs subject to § 263A, the taxpayer must revalue the items or costs included in its beginning inventory in the year of change as if the new method (that is, the method to which the taxpayer is changing) had been in effect during all prior years. This section further provides three methods to revalue an inventory, including the 3-year average method provided by section 1.263A-7(c)(2)(v).

The purpose of the § 481(a) adjustment is to ensure that a taxpayer that changes its method of accounting takes into account those adjustments necessary to prevent amounts from being duplicated or omitted. Generally, when a taxpayer changes its method of valuing or costing its inventory the taxpayer is required to compute a § 481(a) adjustment by revaluing its beginning inventory in the year of change as if the new method had been in effect in all prior years. In this case, Taxpayer changed the method it used to compute a cost complement for purposes of the retail method under § 1.471-8. Thus, Taxpayer’s § 481(a) adjustment should be the difference between the value of its beginning inventory under the new method and the value of its beginning inventory under its prior method.

Section 1.263A-7(c) provides guidance to taxpayers changing their methods of accounting for costs subject to § 263A. Moreover, the regulation provides that a taxpayer using the dollar-value LIFO method of accounting for inventories may revalue all existing LIFO layers of a trade or business based on the 3-year average method. The 3-year average method is based on the average percentage change (the 3-year revaluation factor) in the current costs of inventory for each LIFO pool based on the three most recent taxable years for which the taxpayer has sufficient information. The 3-year revaluation factor is applied to all layers for each pool in beginning inventory in the year of change. Taxpayer used the 3-year average method to compute its § 481(a) adjustment when it changed its method of accounting. However, contrary to its assertions, Taxpayer’s change in method and its resulting § 481(a) adjustment was not governed by § 263A and the regulations thereunder.

The provisions of § 1.263A-7 may be traced to the legislative history of § 263A. The legislative history indicates that when taxpayers became subject to the new § 263A they were required to change their method of accounting for inventories to comply with the new capitalization rules. This in turn required taxpayers to revalue their inventories as if the new rules of § 263A had applied in all prior periods and to take into account adjustments under § 481(a) for the resulting change in inventory values. The legislative history acknowledged that calculating the required revaluations might be onerous for some taxpayers and, therefore, urged the Treasury to develop simplified revaluation methods. Two such methods are demonstrated by detailed examples: a weighted average method and the 3-year average method for dollar-value LIFO inventories. See H. R. Rep. No. 426, 99th Cong., 1st Sess. 632-637; S. Rep. No. 313, 99th Cong., 2d Sess. 146-152; [*28] H.R. Rep. 841, 99th Cong., 2d Sess. II-304 - II-308 (Conference Report, TRA 1986).

Temp. Treas. Reg. § 1.263A-1T contained the initial temporary regulations under § 263A. See T.D. 8131, 1987-1 C.B. 98. Consistent with the legislative history, § 1.263A-1T(e) required taxpayers to change their methods of accounting for inventories to comply with § 263A. The required change was to be made by revaluing the items or costs included in beginning inventory in the year of change as if the new capitalization rules of § 263A and § 1.263A-1T had been in effect during all prior periods. Section 1.263A-1T(e) incorporated and expanded upon the simplified inventory revaluation methods suggested by the legislative history, including the weighted average method (§ 1.263A-1T(e)(6)(iii), subsequently renumbered as § 1.263A-7T(e)(6)(iii)) and the 3- year average method (§ 1.263A-1T(e)(6)(iv), subsequently renumbered as § 1.263A-7T(e)(6)(iv)). The text of § 1.263A-1T(e) clearly indicates throughout that the inventory revaluation provisions, including the 3-year average method, apply to the revaluations required by the enactment of § 263A.

In 1994, the accounting method change provisions of § 1.263A-1T(e) were redesignated as § 1.263A-7T(e). T.D. 8559, 1994-2 C.B. 32. As part of this redesignation, numerous clarifying changes in wording were made to remove references to § 1.263A-1T that were present in § 1.263A-1T(e), but no substantive changes were made.

In 1997, § 1.263A-7T was replaced with § 1.263A-7, the final regulations for § 263A accounting method changes. See T.D. 8728, 1997-2 C.B. 24. The inventory revaluation provisions of § 1.263A-7 are substantially similar to those in § 1.263A-7T. Several of the revaluation methods from § 1.263A-7T(e) are also incorporated into the final regulations, including the 3-year average method. See § 1.263A-7(c)(2)(v).

In addition to the history of § 1.263A-7, the language of the regulation itself clearly indicates that it applies only to accounting method changes where the taxpayer changes its method of accounting for costs subject to § 263A. Specifically, § 1.263A-7(a)(1) introduces the regulation by stating that "The principal purpose of these regulations is to provide guidance regarding how taxpayers are to revalue property on hand at the beginning of the taxable year in which they change their method of accounting for costs subject to section 263A."

Moreover, as is discussed above, following the enactment of § 263A, taxpayers were required to change their methods of accounting for costs subject to § 263A. Generally, when a taxpayer changes its method of accounting it must secure the consent of the Commissioner prior to computing its income under the new method. See § 1.446-1(e)(2)(i). However, Treasury recognized the burden that would have been created if the Commissioner was required to consent to every change in method of accounting required by the enactment of § 263A. Consequently, the temporary regulations provided that a taxpayer that was required to change its method of accounting to comply with the rules under § 263A could automatically change its method of accounting using the procedures prescribed by the Commissioner. See § 1.263A-1T(e)(11)(i). The temporary regulation also provided that other changes in method of accounting were not eligible for the special automatic change procedures. In particular, the temporary regulations specifically excluded changes within inventory valuation methods. See § 1.263A-1T(e)(11)(iii).

Subsequent to the issuance of the temporary regulations, several questions arose regarding what changes were eligible for the automatic change provisions. The Service addressed these questions in Rev. Rul. 89-107, 1989-2 C.B. 62. Specifically, Situation 2 of Rev. Rul. 89-107 described a hypothetical taxpayer that wished to change its method of determining the cost complement for purposes of the retail method and to capitalize in inventory all costs required by the enactment of § 263A. In that situation, the hypothetical taxpayer had been improperly using promotional markdowns as an adjustment to retail prices in the denominator of its cost complement. Given this situation, the revenue ruling concluded that the change from the method of using temporary markdowns as an adjustment to retail prices in computing the cost complement for purposes of the retail method was not a change required by the enactment of § 263A. Therefore, the automatic change provision provided by the temporary regulation was not available for the taxpayer's change in accounting method.

Similarly, the final regulation, § 1.263A-7, provides guidance when a taxpayer changes its method of accounting for costs subject to § 263A. The section also provides that changes in method of accounting for costs subject to § 263A do not include changes relating to factors other than those described therein. The section then provides examples of changes that are not changes in method of accounting for costs subject to § 263A. In particular, the regulation states that a change in method of accounting for costs subject to § 263A does not include a change from one inventory valuation method to another inventory valuation method under § 471 or a change within the LIFO inventory method. See § 1.263A-7(a)(5).

Taxpayer's change in method involved its method of determining its cost complements for purposes of the retail method provided by § 1.471-8. As explained in § 1.263A-5 and situation 2 of Rev. Rul. 89-107, this type of change is not a change in accounting for costs subject to § 263A. Consequently, Taxpayer is not entitled to use any of the revaluation methods described in § 1.263A-7 to revalue its inventory and, therefore, may not use the 3-year average method provided by § 1.263A-7(c)(2)(v).

Moreover, we also understand that Taxpayer has argued that the National Office letter, dated Date 3, granted it consent to use the 3-year average method. This position is incorrect.

First, Taxpayer's position is contrary to the language of the letter ruling that was issued and signed by it. Although it is clear that the National Office was aware that Taxpayer's proposed § 481(a) adjustment was computed using the 3-year average method provided by § 1.263A-7(c)(2), it is also clear that the ruling letter did not express any opinion regarding Taxpayer's use of the method. Instead, the ruling letter specifically provides that the District Director, and not the National Office, would determine the propriety of the method used to compute the § 481(a) adjustment. Moreover, the letter the National Office sent to Taxpayer on Date 3 did not express any opinion regarding the propriety of Taxpayer's use of the 3-year average method. Instead, the letter merely sought additional information regarding Taxpayer's use of that method and a representation that in computing its § 481(a) adjustment it was adjusting all of its existing LIFO layers.

For the above reasons, we conclude that Taxpayer was not entitled to use the 3-year method provided by § 1.263A-7 to compute its § 481(a) adjustment.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Since we have determined that Taxpayer was not entitled to calculate its § 481(a) adjustment using the 3-year average method under § 1.263A-7(c)(2)(v), its § 481(a) adjustment was subject only to the general principles of §§ 446 and 481. However, an argument may exist that Taxpayer's use of the 3-year average method was reasonable under these principles. Although, the letter ruling letter left this determination to the District Director, Taxpayer may attempt to argue that its use of the 3-year average method was reasonable.

The request for field service indicates that Taxpayer computed its 3-year average revaluation factor using 3 years that were overvalued because it had made an unauthorized change in accounting method sometime between Year 1 and Year 5. The request for field service advice also indicates that Taxpayer's LIFO layers that arose prior to Year 1 were properly valued and that Taxpayer did not adjust its 3-year average revaluation factor when it applied the revaluation factor to those years. These facts strongly suggest that Taxpayer's use of the 3-year average was unreasonable.

However, these facts do not provide enough information for us to make a definitive determination regarding the reasonableness of Taxpayer's use of the 3-year average method. [redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call (202) 622-4970 if you have any further questions.

Associate Chief Counsel (Income Tax
& Accounting)(CC:ITA)
By: THOMAS LUXNER
Branch Chief
CC:ITA:06