## Section 263A.—Capitalization and Inclusion in Inventory Costs of Certain Expenses

*26 CFR 1.263A–7: Changing a method of accounting under section 263A.*

### T.D. 8728

### DEPARTMENT OF THE TREASURY
### Internal Revenue Service
### 26 CFR Part 1

## Procedure for Changing a Method of Accounting under Section 263A

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations relating to the requirements for changing a method of accounting for costs subject to section 263A. The regulations provide guidance regarding changes in method of accounting for costs incurred in producing property and acquiring property for resale. The regulations affect taxpayers changing their method of accounting for costs subject to section 263A.

DATES: These regulations are effective August 5, 1997.

FOR FURTHER INFORMATION CONTACT: Cheryl Lynn Oseekey, (202) 622-4970 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

*Background*

On March 30, 1987 and August 7, 1987, temporary regulations under section 263A were published in the **Federal Register** (T.D. 8131, 52 F.R. 10052 [1987–1 C.B. 98] and T.D. 8148, 52 F.R. 29375 [1987–2 C.B. 70]), and cross-referenced to notices of proposed rulemaking published in the **Federal Register** on the same date (52 F.R. 10118 [LR–168–86, 1987–1 C.B. 808]and 52 F.R. 29391 [LR–37–87, 1987–2 C.B. 1054]). The temporary regulations contain rules for taxpayers changing their method of accounting to comply with the capitalization rules of section 263A. A public hearing on these temporary and proposed regulations was held on December 7, 1987.

On August 9, 1993, final regulations under section 263A were published in the **Federal Register** (T.D. 8482, 58 F.R. 42198 [1993 C.B. 77]). These final regulations did not address the accounting method provisions in the 1987 temporary regulations, which continued in effect. On August 5, 1994, final and temporary regulations were published in the **Federal Register** (T.D. 8559, 59 F.R. 39958 [1994–2 C.B. 32]). These final regulations address "pick and pack costs" and other expenses. The August 5, 1994 temporary regulations renumbered the accounting method provisions in the 1987 temporary regulations from §1.263A–1T(e) to §1.263A–7T.

This document adopts, with modifications, §1.263A–7T as final regulations.

*Explanation of Provisions*

In 1987, the IRS and the Treasury Department issued temporary regulations that provide guidance to taxpayers changing their method of accounting to comply with the capitalization rules of section 263A. The regulations provide automatic consent for taxpayers required to change their method of accounting for the first taxable year section 263A was effective.

Subsequent to promulgation of the 1987 temporary regulations, the IRS and the Treasury Department issued various revenue procedures that set forth rules and procedures applicable to certain changes in method of accounting for costs subject to section 263A for which taxpayers can obtain automatic consent. These revenue procedures provide automatic consent to change the method of accounting in years other than the first taxable year section 263A was effective. Where automatic consent is not available by revenue procedure, taxpayers can obtain the Commissioner's consent to change a method of accounting for costs subject to section 263A under Rev. Proc. 97–27 (1997–21 I.R.B. 10).

Rev. Proc. 97–27 and the automatic change revenue procedures describe how a change in method of accounting may be effected, but they do not describe how inventory and other property on hand at the beginning of the year of change should be revalued. These final regulations provide guidance regarding how taxpayers must revalue property in connection with a change in method of accounting for costs subject to section 263A. The revaluation rules for inventory are substantially similar to the revaluation rules contained in the 1987 temporary regulations. Section 1.263A–7(c) provides guidance regarding how items or costs included in beginning inventory in the year of change must be revalued. Section 1.263A–7(d) provides guidance regarding how non-inventory property on hand at the beginning of the year of change must be revalued.

The regulations also provide certain rules that apply to changes in method of accounting for costs subject to section 263A, in addition to the rules and procedures that apply under the applicable revenue procedures. See, §1.263A–7(b).

In addition, the regulations clarify whether certain changes are changes in method of accounting under section 263A and therefore are within the scope of the regulations. For example, a change from one permissible capitalization method, such as the simplified resale method in former §1.263A–1T(d)(4), to another permissible capitalization method, such as the simplified resale method in §1.263A-3(d), is a change in method of accounting under section 263A and is therefore within the scope of the regulations. See §1.263A–7(a)(5).

The final regulations delete certain provisions of §1.263A–7T that were primarily applicable to accounting method changes made in 1987. For example, the final regulations do not incorporate provisions such as §1.263A–7T(e)(2), which provide automatic consent to make the change in method of accounting for the first taxable year section 263A was effective, and §1.263A–7T(e)(7)(iii), (iv) and (v) and §1.263A–7T(e)(8), which provide special rules for adjusting the revaluation factor for costs attributable to different methods of accounting for depreciation (including cost recovery) and differences in the percentage of fixed indirect production costs that were expensed by taxpayers using the practical capacity concept.

*Certain Administrative Guidance*

The final regulations incorporate the provisions of Notice 88–23 (1988–1 C.B. 490) (ordering rules for accounting method changes), and sections IV (A) (guidance regarding deferred intercompany exchanges) and IV (B) (permission to elect a new base year for taxpayers using the last-in, first-out (LIFO) inventory method) of Notice 88-86 (1988–2 C.B. 401). These notices or portions thereof are withdrawn for taxable years to which this Treasury decision applies.

*Effect on other documents*

The following publications are obsolete as of August 5, 1997:

Notice 88–23 (1988–1 C.B. 490).

Notice 88–86 (1988–2 C.B. 401), sections IV (A) and IV (B).

*Public Comments*

The IRS and the Treasury Department received a number of comments in response to the 1987 temporary and proposed regulations. Most of the comments received in response to the temporary regulations issued in March 1987 were considered in connection with the temporary regulations issued in August 1987. In general, those comments are not discussed again here.

*REVALUING BEGINNING INVENTORY—THE 3-YEAR AVERAGE METHOD*

*A. Extending availability of the method*

Under the temporary regulations, taxpayers using the dollar-value LIFO inventory method were permitted to use a 3-year average method for revaluing their beginning inventory in the year they changed their method of accounting to comply with section 263A. Several commentators suggested that taxpayers other than those on the dollar-value LIFO inventory method should also be permitted to use this 3-year average method for revaluing beginning inventory in the year of change. Specifically, commentators suggested that the 3-year average method be made available to taxpayers using the specific goods LIFO inventory method. Another suggestion was that taxpayers using the first-in, first-out (FIFO) inventory method should be permitted to use the 3-year average method even though those taxpayers may have sufficient information to revalue their inventory under the facts and circumstances method.

The final regulations do not adopt these suggestions. The House and Senate Reports to the Tax Reform Act of 1986 indicate Congress intended that taxpayers generally revalue their inventory in the year of change using the facts and circumstances method. Because Congress realized that dollar-value LIFO taxpayers may not have the data needed to use the facts and circumstances method, it suggested two other revaluation methods that could be used in conjunction with, or in lieu of, the facts and circumstances method. The 3-year average method was one of those other methods. H.R. Rep. No. 426, 99th Cong., 1st Sess. 633–637 (1985), 1986–3 (Vol. 2) C.B. 633–637 and S. Rep. No. 313, 99th Cong., 2nd Sess. 147–152 (1986), 1986–3 (Vol. 3) C.B. 147–152. The IRS and the Treasury Department believe that limiting the 3-year average method to dollar-value LIFO taxpayers is more consistent with legislative history which expresses Congress' concern that dollar-value LIFO taxpayers may have particular problems in revaluing inventory. H.R. Rep. No. 426, 633, 1986–3 (Vol. 2) C.B. 633 and S. Rep. No. 313, 147, 1986–3 (Vol.3) C.B. 147.

*B. Altering the mechanics of the method*

One commentator suggested that taxpayers be permitted to revalue items or costs included in beginning inventory in the year of change by using data from the year of change instead of data from the prior three years, and calculate a section 481(a) adjustment accordingly. This commentator further suggested that three years after the year of change, the taxpayer would recompute the section 481(a) adjustment using data from the three new years to test its original adjustment under section 481(a). If the new adjustment were larger than the original adjustment by a substantial amount, the taxpayer would be required to amend its federal income tax returns. The final regulations do not adopt this suggestion. Requiring taxpayers to compute two adjustments under section 481(a) would unnecessarily complicate application of the 3-year average method.

Another commentator suggested that some taxpayers be permitted to revalue items or costs included in beginning inventory in the year of change by using data from the immediately preceding year rather than the prior three years. This proposal to use only the prior year's data would be limited to taxpayers that can show they have not had a significant change in costs over the preceding three years. This suggested modification to the 3-year average method was not adopted. The suggested modification would not substantially simplify the process of revaluing beginning inventory because taxpayers would be required to determine whether their costs significantly changed during the preceding three-year period.

*C. Limiting costs subject to revaluation*

One commentator suggested that LIFO layers should be revalued only if the items of inventory comprising those layers are still in existence in the year of change. This suggestion was not adopted. However, the final regulations continue the rule in the temporary regulations that taxpayers may adjust the revaluation factor (under either the 3-year average method or the weighted average method) to the extent they can show that additional section 263A costs included in the calculation of the revaluation factor were not incurred in the prior years in which the LIFO layers were accumulated.

*D. New base year*

Under the 3-year average method, taxpayers generally are required to establish a new base year. Several commentators commented that requiring link-chain LIFO taxpayers to establish a new base year is costly and pointless and suggested that these taxpayers be excluded from the general requirement that all dollar-value LIFO taxpayers establish a new base year. The IRS and the Treasury Department did not adopt this suggestion. If a new base year is not established, the current-year index, determined under the taxpayer's new method of accounting, would be multiplied by the prior-year cumulative index, determined under the taxpayer's former method of accounting, and could distort the taxpayer's LIFO inventory valuation. This distortion is eliminated when the taxpayer establishes a new base year and establishes a new index. Accordingly, the final regulations provide that all dollar-value LIFO taxpayers (whether using double extension or link-chain) should generally establish a new base year when they use the 3-year average method to revalue their inventories under section 263A.

Commentators also suggested that taxpayers using the 3-year average method and either the simplified production method or the simplified resale method be allowed, but not required, to establish a new base year. Section IV (B) of Notice 88-86 permits these taxpayers to choose whether to establish a new base year. This rule is incorporated into the final regulations.

One commentator noted that the example in the 1987 temporary regulations illustrating the 3-year average method did not use the current year revaluation factor in computing the updated base year cost of inventory. The example has been revised to use the current year revaluation factor.

*REVALUING BEGINNING INVENTORY—FACTS AND CIRCUMSTANCES METHOD*

One commentator suggested that specific rules or guidelines be adopted to clarify what is a reasonable estimate or procedure for revaluing beginning inventory in connection with a change in method of accounting. This suggestion was not adopted. What is a reasonable estimate or procedure must be decided on a case-by-case basis in light of all applicable facts and circumstances. The final regulations continue the provision in the temporary regulations that permissible estimates and procedures include using information from a more recent period to estimate the amount and nature of inventory costs applicable to earlier periods, and using information with respect to comparable items of inventory to estimate the costs associated with other items of inventory.

*NEW BASE YEAR WHEN THE 3-YEAR AVERAGE METHOD IS NOT USED*

Several commentators suggested that dollar-value LIFO taxpayers not using the 3-year average method to revalue beginning inventory be permitted to update their base year if they so choose. Section IV (B) of Notice 88–86 permits these taxpayers to establish a new base year. The final regulations adopt this rule.

*SCOPE OF ACCOUNTING METHOD CHANGE*

Several commentators suggested that the regulations should allow taxpayers to change from the specific goods LIFO inventory method to the dollar-value LIFO inventory method in connection with changing their method of accounting for costs under section 263A without obtaining the Commissioner’s consent. Generally, taxpayers must secure the Commissioner’s consent before effecting a change in method of accounting under section 446(e) unless this requirement is specifically waived. The IRS and the Treasury Department do not believe an exception from this general rule is warranted for changes from the specific goods LIFO inventory method to the dollar-value LIFO inventory method except to the extent permitted by §1.472–8(f)(1).

Several commentators also suggested that taxpayers that change their method of accounting for costs subject to section 263A be permitted to make additional changes in their methods of accounting in future tax years under section 263A without obtaining additional consents from the Commissioner. The IRS and the Treasury Department have issued various revenue procedures that provide automatic consent procedures for taxpayers to change their method of accounting for costs under section 263A.

One commentator suggested that the regulations provide that when making the change from the full absorption rules of §1.471–11 to the uniform capitalization rules of section 263A, taxpayers may cease taking into account any costs not treated as inventoriable under section 263A that may have been erroneously inventoried under prior law. The temporary regulations issued in August 1987 and the final regulations permit this result. In revaluing beginning inventory to include additional section 263A costs, taxpayers may cease capitalizing costs that had been capitalized but are not required to be capitalized under section 263A.

*AUDIT PROTECTION*

Several commentators noted that taxpayers should be guaranteed audit protection for costs or items that are part of a change in method of accounting under section 263A. The IRS’ long-standing administrative position is that if a taxpayer files an application to change its method of accounting in accordance with the applicable administrative guidance, for example, Rev. Proc. 97–27, an examining agent may not later propose that the taxpayer change its method of accounting for the same item for a taxable year prior to the year of change.

*ORDERING RULES*

One commentator suggested that overall accounting method changes (for example, the cash receipts and disbursements method to an accrual method) should be implemented prior to any change in method of accounting for costs under section 263A. The temporary regulations generally provide that a change in method of accounting for costs under section 263A is deemed to occur prior to any other change in method of accounting effected during the year of change. The final regulations continue that general rule with four modifications. Taxpayers that are discontinuing the LIFO inventory method may make that change prior to a change in method of accounting under section 263A. Additionally, taxpayers that are changing from the specific goods LIFO inventory method to the dollar-value LIFO inventory method may make that change prior to a change in method of accounting under section 263A. Also, taxpayers that are changing their overall method of accounting from the cash method to an accrual method must make the change to an accrual method prior to a change in method of accounting under section 263A. Finally, taxpayers that are changing their method of accounting for depreciation when any portion of the depreciation is subject to section 263A must make the method change for depreciation prior to a change in method of accounting under section 263A.

*COST ALLOCATION METHOD*

Several commentators suggested that the regulations be clarified to provide that a taxpayer must use the same cost allocation method to restate its beginning inventory and to value its ongoing inventory. The final regulations clarify this point. Inventory on hand at the beginning of the year of change is revalued as if the taxpayer's new method had applied to all prior periods. The same cost allocation method must be used both retroactively (for purposes of restating beginning inventory) and prospectively (for purposes of the current year and all subsequent years, unless the taxpayer seeks specific consent from the Commissioner to change this method of accounting).

*INTERCOMPANY ITEMS*

One commentator suggested that taxpayers be given automatic consent to discontinue filing consolidated federal income tax returns so that they could avoid the need to revalue the amount of intercompany items resulting from the sale or exchange of inventory property in intercompany transactions. The regulations do not adopt this suggestion. Generally, taxpayers must secure the Commissioner's consent before discontinuing the filing of consolidated tax returns. The IRS and the Treasury Department do not think an exception from this general rule is warranted in this situation.

*Effective Date*

These regulations are effective for taxable years beginning on or after August 5, 1997.

*Special Analyses*

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations were submitted to the Small Business Administration for comment on their impact on small business.

*Drafting Information*

The principal author of these regulations is Cheryl Lynn Oseekey, Office of Assistant Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in their development.

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*Adoption of Amendments to the Regulations*

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.263A–0 is amended by revising the introductory text and adding entries for §1.263A–7 to read as follows:

*§1.263A–0 Outline of regulations under section 263A.*

This section lists the paragraphs in §§1.263A–1 through 1.263A–3 and §1.263A–7 through 1.263A-15.

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*§1.263A–7 Changing a method of accounting under section 263A.*

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(v) Related corporation.
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(1) Need for adjustments.
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*§1.263A–1 [Amended]*

Par. 3. Section 1.263A–1 is amended by removing "1.263A–7T (e) generally" from the last sentence in paragraph (a)(2)(i) and replacing it with "1.263A–7".

Par. 4. Section 1.263A–7 is added to read as follows:

*§1.263A–7 Changing a method of accounting under section 263A.*

(a) *Introduction*—(1) *Purpose.* These regulations provide guidance to taxpayers changing their methods of accounting for costs subject to section 263A. 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. Paragraph (c) of this section provides guidance regarding how items or costs included in beginning inventory in the year of change must be revalued. Paragraph (d) of this section provides guidance regarding how non-inventory property should be revalued in the year of change.

(2) *Taxpayers that adopt a method of accounting under section 263A.* Taxpayers may adopt a method of accounting for costs subject to section 263A in the first taxable year in which they engage in resale or production activities. For purposes of this section, the adoption of a method of accounting has the same meaning as provided in §1.446–1(e)(1). Taxpayers are not subject to the provisions of these regulations to the extent they adopt, as opposed to change, a method of accounting.

(3) *Taxpayers that change a method of accounting under section 263A.* Taxpayers changing their method of accounting for costs subject to section 263A are subject to the revaluation and other provisions of this section. Taxpayers subject to these regulations include, but are not limited to—

(i) Resellers of personal property whose average annual gross receipts for the immediately preceding 3-year period (or lesser period if the taxpayer was not in existence for the three preceding taxable years) exceed $10,000,000 where the taxpayer was not subject to section 263A in the prior taxable year;

(ii) Resellers of real or personal property that are using a method that fails to comply with section 263A and desire to change to a method of accounting that complies with section 263A;

(iii) Producers of real or tangible personal property that are using a method that fails to comply with section 263A and desire to change to a method of accounting that complies with section 263A; and

(iv) Resellers and producers that desire to change from one permissible method of accounting for costs subject to section 263A to another permissible method.

(4) *Effective date.* The provisions of this section are effective for taxable years beginning on or after August 5, 1997. For taxable years beginning before August 5, 1997, the rules of §1.263A–7T contained in the 26 CFR part 1 edition revised as of April 1, 1997, as modified by other administrative guidance, will apply.

(5) *Definition of change in method of accounting.* For purposes of this section, a change in method of accounting has the same meaning as provided in §1.446–1(e)(2)(ii). Changes in method of accounting for costs subject to section 263A include changes to methods required or permitted by section 263A and the regulations thereunder. Changes in method of accounting may be described in the preceding sentence irrespective of whether the taxpayer's previous method of accounting resulted in the capitalization of more (or fewer) costs than the costs required to be capitalized under section 263A and the regulations thereunder, and irrespective of whether the taxpayer's previous method of accounting was a permissible method under the law in effect when the method was being used. However, changes in method of accounting for costs subject to section 263A do not include changes relating to factors other than those described therein. For example, a change in method of accounting for costs subject to section 263A does not include a change from one inventory identification method to another inventory identification method, such as a change from the last-in, first-out (LIFO) method to the first-in, first-out (FIFO) method, or vice versa, or a change from one inventory valuation method to another inventory valuation method under section 471, such as a change from valuing inventory at cost to valuing the inventory at cost or market, whichever is lower, or vice versa. In addition, a change in method of accounting for costs subject to section 263A does not include a change within the LIFO inventory method, such as a change from the double extension method to the link-chain method, or a change in the method used for determining the number of pools. Further, a change from the modified resale method set forth in Notice 89-67 (1989–1 C.B. 723), see §601.601(d)(2) of this chapter, to the simplified resale method set forth in §1.263A–3(d) is not a change in method of accounting within the meaning of §1.446–1(e)(2)(ii) and is therefore not subject to the provisions of this section. However, a change from the simplified resale method set forth in former §1.263A–1T(d)(4) to the simplified resale method set forth in §1.263A–3(d) is a change in method of accounting within the meaning of §1.446–1(e)(2)(ii) and is subject to the provisions of this section.

(b) *Rules applicable to a change in method of accounting*—(1) *General rules.* All changes in method of accounting for costs subject to section 263A are subject to the rules and procedures provided by the Code, regulations, and administrative procedures applicable to such changes. The Internal Revenue Service has issued specific revenue procedures that govern certain accounting method changes for costs subject to section 263A. Where a specific revenue procedure is not applicable, changes in method of accounting for costs subject to section 263A are subject to the same rules and procedures that govern other accounting method changes. See Rev. Proc. 97–27 (1997–21 I.R.B. 10) and §601.601(d)(2) of this chapter.

(2) *Special rules*—(i) *Ordering rules when multiple changes in method of accounting occur in the year of change.*

(A) *In general.* A change in method of accounting for costs subject to section 263A is generally deemed to occur (including the computation of the adjustment under section 481(a)) before any other change in method of accounting is deemed to occur for that same taxable year.

(B) *Exceptions to the general ordering rule*—(*1*) *Change from the LIFO inventory method.* In the case of a taxpayer that is discontinuing its use of the LIFO inventory method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the change from the LIFO method may be made before the change in method of accounting (and the computation of the corresponding adjustment under section 481 (a)) under section 263A is made.

(*2*) *Change from the specific goods LIFO inventory method.* In the case of a taxpayer that is changing from the specific goods LIFO inventory method to the dollar-value LIFO inventory method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the change from the specific goods LIFO inventory method may be made before the change in method of accounting under section 263A is made.

(*3*) *Change in overall method of accounting.* In the case of a taxpayer that is changing its overall method of accounting from the cash receipts and disbursements method to an accrual method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the taxpayer must change to an accrual method for capitalizable costs (see §1.263A–1(c)(2)(ii)) before the change in method of accounting (and the computation of the corresponding adjustment under section 481(a)) under section 263A is made.

(*4*) *Change in method of accounting for depreciation.* In the case of a taxpayer that is changing its method of accounting for depreciation in the same taxable year it is changing its method of accounting for costs subject to section 263A and any portion of the depreciation is subject to section 263A, the change in method of accounting for depreciation must be made before the change in method of accounting (and the computation of the corresponding adjustment under section 481(a)) under section 263A is made.

(ii) *Adjustment required by section 481(a).* In the case of any taxpayer required or permitted to change its method of accounting for any taxable year under section 263A and the regulations thereunder, the change will be treated as initiated by the taxpayer for purposes of the adjustment required by section 481(a). The adjustment required by section 481(a) is to be taken into account in computing taxable income over a period not to exceed 4 taxable years.

(iii) *Base year*—(A) *Need for a new base year.* Certain dollar-value LIFO taxpayers (whether using double extension or link-chain) must establish a new base year when they revalue their inventories under section 263A.

(*1*) *Facts and circumstances revaluation method used.* A dollar-value LIFO taxpayer that uses the facts and circumstances revaluation method is permitted, but not required, to establish a new base year.

(*2*) *3-year average method used*—(*i*) *Simplified method not used.* A dollar-value LIFO taxpayer using the 3-year average method but not the simplified production method or the simplified resale method to revalue its inventory is required to establish a new base year.

(*ii*) *Simplified method used.* A dollar-value LIFO taxpayer using the 3-year average method and either the simplified production method or the simplified resale method to revalue its inventory is permitted, but not required, to establish a new base year.

(B) *Computing a new base year.* For purposes of determining future indexes, the year of change becomes the new base year (that is, the index at the beginning of the year of change generally must be 1.00) and all costs are restated in new base year costs for purposes of extending such costs in future years. However, when a new base year is established, costs associated with old layers retain their separate identity within the base year, with such layers being restated in terms of the new base year index. For example, for purposes of determining whether a particular layer has been invaded, each layer must retain its separate identity. Thus, if a decrement in an inventory pool occurs, layers accumulated in more recent years must be viewed as invaded first, in order of priority.

(c) *Inventory*—(1) *Need for adjustments*. When a taxpayer changes its method of accounting for costs subject to section 263A, the taxpayer generally must, in computing its taxable income for the year of change, take into account the adjustments required by section 481(a). The adjustments required by section 481(a) relate to revaluations of inventory property, whether the taxpayer produces the inventory or acquires it for resale. See paragraph (d) of this section in regard to the adjustments required by section 481(a) that relate to non-inventory property.

(2) *Revaluing beginning inventory*—(i) *In general.* If a taxpayer changes its method of accounting for costs subject to section 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. In revaluing inventory costs under this procedure, all of the capitalization provisions of section 263A and the regulations thereunder apply to all inventory costs accumulated in prior years. The necessity to revalue beginning inventory as if these capitalization rules had been in effect for all prior years includes, for example, the revaluation of costs or layers incurred in taxable years preceding the transition period to the full absorption method of inventory costing as described in §1.471–11(e), regardless of whether a taxpayer employed a cut-off method under those regulations. The difference between the inventory as originally valued using the former method (that is, the method from which the taxpayer is changing) and the inventory as revalued using the new method is equal to the amount of the adjustment required under section 481(a).

(ii) *Methods to revalue inventory.* There are three methods available to revalue inventory. The first method, the facts and circumstances revaluation method, may be used by all taxpayers. Under this method, a taxpayer determines the direct and indirect costs that must be assigned to each item of inventory based on all the facts and circumstances. This method is described in paragraph (c)(2)(iii) of this section. The second method, the weighted average method, is available only in certain situations to taxpayers using the FIFO inventory method or the specific goods LIFO inventory method. This method is described in paragraph (c)(2)(iv) of this section. The third method, the 3-year average method, is available to all taxpayers using the dollar-value LIFO inventory method of accounting. This method is described in paragraph (c)(2)(v) of this section. The weighted average method and the 3-year average method revalue inventory through processes of estimation and extrapolation, rather than based on the facts and circumstances of a particular year's data. All three methods are available regardless of whether the taxpayer elects to use a simplified method to capitalize costs under section 263A.

(iii) *Facts and circumstances revaluation method*—(A) *In general.* Under the facts and circumstances revaluation method, a taxpayer generally is required to revalue inventories by applying the capitalization rules of section 263A and the regulations thereunder to the production and resale activities of the taxpayer, with the same degree of specificity as required of inventory manufacturers under the law immediately prior to the effective date of the Tax Reform Act of 1986 (Public Law 99–514, 100 Stat. 2085, 1986–3 C.B. (Vol. 1)). Thus, for example, with respect to any prior year that is relevant in determining the total amount of the revalued balance as of the beginning of the year of change, the taxpayer must analyze the production and resale data for that particular year and apply the rules and principles of section 263A and the regulations thereunder to determine the appropriate revalued inventory costs. However, under the facts and circumstances revaluation method, a taxpayer may utilize reasonable estimates and procedures in valuing inventory costs if—

(*1*) The taxpayer lacks, and is not able to reconstruct from its books and records, actual financial and accounting data which is required to apply the capitalization rules of section 263A and the regulations thereunder to the relevant facts and circumstances surrounding a particular item of inventory or cost; and

(*2*) The total amounts of costs for which reasonable estimates and procedures are employed are not significant in comparison to the total restated value (including costs previously capitalized under the taxpayer's former method) of the items or costs for the period in question.

(B) *Exception.* A taxpayer that is not able to comply with the requirement of paragraph (c)(2)(iii)(A)(*2*) of this section because of the existence of a significant amount of costs that would require the use of estimates and procedures must revalue its inventories under the procedures provided in paragraph (c)(2)(iv) or (v) of this section.

(C) *Estimates and procedures allowed.* The estimates and procedures of this paragraph (c)(2)(iii) include—

(*1*) The use of available information from more recent years to estimate the amount and nature of inventory costs applicable to earlier years; and

(*2*) The use of available information with respect to comparable items of inventory produced or acquired during the same year in order to estimate the costs associated with other items of inventory.

(D) *Use by dollar-value LIFO taxpayers.* Generally, a dollar-value LIFO taxpayer must recompute its LIFO inventory for each taxable year that the LIFO inventory method was used.

(E) *Examples.* The provisions of this paragraph (c)(2)(iii) are illustrated by the following three examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in all three examples is 1997. The examples read as follows:

*Example 1.* Taxpayer X lacks information for the years 1993 and earlier, regarding the amount of costs incurred in transporting finished goods from X's factory to X's warehouse and in storing those goods at the warehouse until their sale to customers. X determines that, for 1994 and subsequent years, these transportation and storage costs constitute 4 percent of the total costs of comparable goods under X's method of accounting for such years. Under this paragraph (c)(2)(iii), X may assume that transportation and storage costs for the years 1993 and earlier constitute 4 percent of the total costs of such goods.

*Example 2.* Assume the same facts as in *Example 1*, except that for the year 1993 and earlier, X used a different method of accounting for inventory costs whereunder significantly fewer costs were capitalized than amounts capitalized in later years. Thus, the application of transportation and storage based on a percentage of costs for 1994 and later years would not constitute a reasonable estimate for use in earlier years. X may use the information from 1994 and later years, if appropriate adjustments are made to reflect the differences in inventory costs for the applicable years, including, for example—

(i) Increasing the percentage of costs that are intended to represent transportation and storage costs to reflect the aggregate differences in capitalized amounts under the two methods of accounting; or

(ii) Taking the absolute dollar amount of transportation and storage costs for comparable goods in inventory and applying that amount (adjusted for changes in general price levels, where appropriate) to goods associated with 1993 and prior periods.

*Example 3.* Taxpayer Z lacks information for certain years with respect to factory administrative costs, subject to capitalization under section 263A and the regulations thereunder, incurred in the production of inventory in factory A. Z does have sufficient information to determine factory administrative costs with respect to production of inventory in factory B, wherein inventory items were produced during the same years as factory A. Z may use the information from factory B to determine the appropriate amount of factory administrative costs to capitalize as inventory costs for comparable items produced in factory A during the same years.

(iv) *Weighted average method*—(A) *In general.* A taxpayer using the FIFO method or the specific goods LIFO method of accounting for inventories may use the weighted average method as provided in this paragraph (c)(2)(iv) to estimate the change in the amount of costs that must be allocated to inventories for prior years. The weighted average method under this paragraph (c)(2)(iv) is only available to a taxpayer that lacks sufficient data to revalue its inventory costs under the facts and circumstances revaluation method provided for in paragraph (c)(2)(iii) of this section. Moreover, a taxpayer that qualifies for the use of the weighted average method under this paragraph (c)(2)(iv) must utilize such method only with respect to items or costs for which it lacks sufficient information to revalue under the facts and circumstances revaluation method. Particular items or costs must be revalued under the facts and circumstances revaluation method if sufficient information exists to make such a revaluation. If a taxpayer lacks sufficient information to otherwise apply the weighted average method under this paragraph (c)(2)(iv) (for example, the taxpayer is unable to revalue the costs of any of its items in inventory due to a lack of information), then the taxpayer must use reasonable estimates and procedures, as described in the facts and circumstances revaluation method, to whatever extent is necessary to allow the taxpayer to apply the weighted average method.

(B) *Weighted average method for FIFO taxpayers*—(1) *In general.* This paragraph (c)(2)(iv)(B) sets forth the mechanics of the weighted average method as applicable to FIFO taxpayers. Under the weighted average method, an item in ending inventory for which sufficient data is not available for revaluation under section 263A and the regulations thereunder must be revalued by using the weighted average percentage increase or decrease with respect to such item for the earliest subsequent taxable year for which sufficient data is available. With respect to an item for which no subsequent data exists, such item must be revalued by using the weighted average percentage increase or decrease with respect to all reasonably comparable items in the taxpayer's inventory for the same year or the earliest subsequent taxable year for which sufficient data is available.

(2) *Example.* The provisions of this paragraph (c)(2)(iv)(B) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

*Example.* Taxpayer A manufactures bolts and uses the FIFO method to identify inventories. Under A's former method, A did not capitalize all of the costs required to be capitalized under section 263A. A maintains inventories of bolts, two types of which it no longer produces. Bolt A was last produced in 1994. The revaluation of the costs of Bolt A under this section for bolts produced in 1994 results in a 20 percent increase of the costs of Bolt A. A portion of the inventory of Bolt A, however, is attributable to 1993. A does not have sufficient data for revaluation of the 1993 cost for Bolt A. With respect to Bolt A, A may apply the 20 percent increase determined for 1994 to the 1993 production as an acceptable estimate. Bolt B was last produced in 1992 and no data exists that would allow revaluation of the inventory cost of Bolt B. The inventories of all other bolts for which information is available are attributable to 1994 and 1995. Revaluation of the costs of these other bolts using available data results in an average increase in inventory costs of 15 percent for 1994 production. With respect to Bolt B, the overall 15 percent increase for A's inventory for 1994 may be used in revaluing the cost of Bolt B.

(C) *Weighted average method for specific goods LIFO taxpayers*—(1) *In general.* This paragraph (c)(2)(iv)(C) sets forth the mechanics of the weighted average method as applicable to LIFO taxpayers using the specific goods method of valuing inventories. Under the weighted average method, the inventory layers with respect to an item for which data is available are revalued under this section and the increase or decrease in amount for each layer is expressed as a percentage of change from the cost in the layer as originally valued. A weighted average of the percentage of change for all layers for each type of good is computed and applied to all earlier layers for each type of good that lack sufficient data to allow for revaluation. In the case of earlier layers for which sufficient data exists, such layers are to be revalued using actual data. In cases where sufficient data is not available to make a weighted average estimate with respect to a particular item of inventory, a weighted average increase or decrease is to be determined using all other inventory items revalued by the taxpayer in the same specific goods grouping. This percentage increase or decrease is then used to revalue the cost of the item for which data is lacking. If the taxpayer lacks sufficient data to revalue any of the inventory items contained in a specific goods grouping, then the weighted average increase or decrease of substantially similar items (as determined by principles similar to the rules applicable to dollar-value LIFO taxpayers in §1.472–8(b)(3)) must be applied in the revaluation of the items in such grouping. If insufficient data exists with respect to all the items in a specific goods grouping and to all items that are substantially similar (or such items do not exist), then the weighted average for all revalued items in the taxpayer's inventory must be applied in revaluing items for which data is lacking.

(2) *Example.* The provisions of this paragraph (c)(2)(iv)(C) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

*Example.* (i) Taxpayer M is a manufacturer that produces two different parts. Under M's former method, M did not capitalize all of the costs required to be capitalized under section 263A. Work-in-process inventory is recorded in terms of equivalent units of finished goods. M's records show the following at the end of 1996 under the specific goods LIFO inventory method:

| *LIFO Product and layer* | *Number* | *Cost* | *Carrying values* |
|---|---|---|---|
| Product #1: | | | |
| 1993 | 150 | $5.00 | $750 |
| 1994 | 100 | 6.00 | 600 |
| 1995 | 100 | 6.50 | 650 |
| 1996 | 50 | 7.00 | 350 |
| | | | $2,350 |
| Product #2: | | | |
| 1993 | 200 | $4.00 | $800 |
| 1994 | 200 | 4.50 | 900 |
| 1995 | 100 | 5.00 | 500 |
| 1996 | 100 | 6.00 | 600 |
| | | | $2,800 |

Total carrying value of Products #1 and #2 under M's former method . . . . . . . . . . . . . . . . . .$5,150

(ii) M has sufficient data to revalue the unit costs of Product #1 using its new method for 1994, 1995 and 1996. These costs are: $7.00 in 1994, $7.75 in 1995, and $9.00 in 1996. This data for Product #1 results in a weighted average percentage change of 20.31 percent [(100 x ($7.00 – $6.00)) + (100 x ($7.75 – $6.50)) + (50 x ($9.00 – $7.00)) divided by (100 x $6.00) + (100 x $6.50) + (50 × $7.00)]. M has sufficient data to revalue the unit costs of Product #2 only in 1995 and 1996. These costs are: $6.00 in 1995 and $7.00 in 1996. This data for Product #2 results in a weighted average percentage change of 18.18 percent [(100 × ($6.00 – $5.00)) + (100 × ($7.00 – $6.00)) divided by (100 × $5.00) + (100 × $6.00)].

(iii) M can estimate its revalued costs for Product #1 for 1993 by applying the weighted average increase computed for Product #1 (20.31 percent) to the unit costs originally carried on M's records for 1993 under M's former method. The estimated revalued unit cost of Product #1 would be $6.02 ($5.00 × 1.2031). M estimates its revalued costs for Product #2 for 1993 and 1994 in a similar fashion. M applies the weighted average increase determined for Product #2 (18.18 percent) to the unit costs of $4.00 and $4.50 for 1993 and 1994 respectively. The revalued unit costs of Product #2 are $4.73 for 1993 ($4.00 × 1.1818) and $5.32 for 1994 ($4.50 × 1.1818).

(iv) M's inventory would be revalued as follows:

| *LIFO Product and layer* | *Number* | *Cost* | *Carrying values* |
|---|---|---|---|
| Product #1: | | | |
| 1993 | 150 | $6.02 | $903 |
| 1994 | 100 | 7.00 | 700 |
| 1995 | 100 | 7.75 | 775 |
| 1996. | 50 | 9.00 | 450 |
| | | | $2,828 |
| Product #2: | | | |
| 1993 | 200 | $4.73 | $946 |
| 1994 | 200 | 5.32 | 1,064 |
| 1995 | 100 | 6.00 | 600 |
| 1996 | 100 | 7.00 | 700 |
| | | | $3,310 |

Total value of Products #1 and #2 as revalued under M's new method . . . . . $6,138

Total amount of adjustment required under section 481(a) [$6,138 – $5,150] . . . . . . . . . $988

(D) *Adjustments to inventory costs from prior years.* For special rules applicable when a revaluation using the weighted average method includes costs not incurred in prior years, see paragraph (c)(2)(v)(E) of this section.

(v) *3-year average method*—(A) *In general.* 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 as provided in this paragraph (c)(2)(v). 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 (typically, the three most recent taxable years of such trade or business). The 3-year revaluation factor is applied to all layers for each pool in beginning inventory in the year of change. The 3-year average method is available to any dollar-value taxpayer that complies with the requirements of this paragraph (c)(2)(v) regardless of whether such taxpayer lacks sufficient data to revalue its inventory costs under the facts and circumstances revaluation method prescribed in paragraph (c)(2)(iii) of this section. The 3-year average method must be applied with respect to all inventory in a taxpayer's trade or business. A taxpayer is not permitted to apply the method for the revaluation of some, but not all, inventory costs on the basis of pools, business units, or other measures of inventory amounts that do not constitute a separate trade or business. Generally, a taxpayer revaluing its inventory using the 3-year average method must establish a new base year. See, paragraph (b)(2)(iii)(A)(2)(i) of this section. However, a dollar-value LIFO taxpayer using the 3-year average method and either the simplified production method or the simplified resale method to revalue its inventory is permitted, but not required, to establish a new base year. See, paragraph (b)(2)(iii)(A)(2)(ii) of this section. If a taxpayer lacks sufficient information to otherwise apply the 3-year average method under this paragraph (c)(2)(v) (for example, the taxpayer is unable to revalue the costs of any of its LIFO pools for three years due to a lack of information), then the taxpayer must use reasonable estimates and procedures, as described in the facts and circumstances revaluation method under paragraph (c)(2)(iii) of this section, to whatever extent is necessary to allow the taxpayer to apply the 3-year average method.

(B) *Consecutive year requirement.* Under the 3-year average method, if sufficient data is available to calculate the revaluation factor for more than three years, the taxpayer may use data from such additional years in determining the average percentage increase or decrease only if the additional years are consecutive to and prior to the year of change. The requirement under the preceding sentence to use consecutive years is applicable under this method regardless of whether any inventory costs in beginning inventory as of the year of change are viewed as incurred in, or attributable to, those consecutive years under the LIFO inventory method. Thus, the requirement to use data from consecutive years may result in using information from a year in which no LIFO increment occurred. For example, if a taxpayer is changing its method of accounting in 1997 and has sufficient data to revalue its inventory for the years 1991 through 1996, the taxpayer may calculate the revaluation factor using all six years. If, however, the taxpayer has sufficient data to revalue its inventory for the years 1990 through 1992, and 1994 through 1996, only the three years consecutive to the year of change, that is, 1994 through 1996, may be used in determining the revaluation factor. Similarly, for example, a taxpayer with LIFO increments in 1995, 1993, and 1992 may not calculate the revaluation factor based on the data from those years alone, but instead must use the data from consecutive years for which the taxpayer has information.

(C) *Example.* The provisions of this paragraph (c)(2)(v) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

*Example.* (i) Taxpayer G, a calendar year taxpayer, is a reseller that is required to change its method of accounting under section 263A. G will not use either the simplified production method or the simplified resale method. G adopted the dollar-value LIFO inventory method in 1991, using a single pool and the double extension method. G's beginning LIFO inventory as of January 1, 1997, computed using its former method, for the year of change is as follows:

| | *Base year costs* | *Index* | *LIFO carrying value* |
|---|---|---|---|
| Base layer . . . | $14,000 | 1.00 | $14,000 |
| 1991 layer . . . . . | 4,000 | 1.20 | 4,800 |
| 1992 layer . . . . . | 5,000 | 1.30 | 6,500 |
| 1993 layer . . . . . | 2,000 | 1.35 | 2,700 |
| 1994 layer. . . . . . . . . | 0 | 1.40 | 0 |
| 1995 layer . . . . . | 4,000 | 1.50 | 6,000 |
| 1996 layer . . . . . | 5,000 | 1.60 | 8,000 |
| Total. . . . . . . . | $34,000 | . . . . | $42,000 |

(ii) G is able to recompute total inventoriable costs incurred under its new method for the three preceding taxable years as follows:

| | *Current cost as recorded (former method)* | *Current cost as adjusted (new method)* | *Percentage change* |
|---|---|---|---|
| 1994 . . . . . . . | $35,000 | $45,150 | .29 |
| 1995 . . . . . . . . | 43,500 | 54,375 | .25 |
| 1996 . . . . . . . . | 54,400 | 70,720 | .30 |
| Total . . . . . . | $132,900 | $170,245 | .28 |

(iii) Applying the average revaluation factor of .28 to each layer, G's inventory is restated as follows:

| | *Restated base year costs* | *Index* | *Restated LIFO carrying value* |
|---|---|---|---|
| Base layer . . . | $17,920 | 1.00 | $17,920 |
| 1991 layer . . . . . | 5,120 | 1.20 | 6,144 |
| 1992 layer . . . . . | 6,400 | 1.30 | 8,320 |
| 1993 layer . . . . | 2,560 | 1.35 | 3,456 |
| 1994 layer . . . . . . . . | 0 | 1.40 | 0 |
| 1995 layer . . . . . | 5,120 | 1.50 | 7,680 |
| 1996 layer . . . . | 6,400 | 1.60 | 10,240 |
| Total . . . . . . . | $43,520 | . . . . | $53,760 |

(iv) The adjustment required by section 481(a) is $11,760. This amount may be computed by multiplying the average percentage of .28 by the LIFO carrying value of G's inventory valued using its former method ($42,000). Alternatively, the adjustment required by section 481(a) may be computed by the difference between—

(*A*) The revalued costs of the taxpayer's inventory under its new method ($53,760), and

(*B*) The costs of the taxpayer's inventory using its former method ($42,000).

(v) In addition, the inventory as of the first day of the year of change (January 1, 1997) becomes the new base year cost for purposes of determining the LIFO index in future years. See, paragraphs (b)(2)(iii)(A)(2)(i) and (b)(2)(iii)(B) of this section. This requires that layers in years prior to the base year be restated in terms of the new base year index. The current year cost of G's inventory, as adjusted, is $70,720. Such cost must be apportioned to each layer in proportion to the restated base year cost of that layer to total restated base year costs ($43,520), as follows:

| | *Restated base year costs* | *Restated index* | *Restated LIFO carrying value* |
|---|---|---|---|
| Old base layer | $29,120 | .615 | $17,920 |
| 1991 layer . . . . . | 8,320 | .738 | 6,144 |
| 1992 layer . . . . | 10,400 | .80 | 8,320 |
| 1993 layer . . . . . | 4,160 | .831 | 3,456 |
| 1994 layer . . . . . . . . | 0 | — | 0 |
| 1995 layer . . . . . | 8,320 | .923 | 7,680 |
| 1996 layer . . . . | 10,400 | .985 | 10,240 |
| Total . . . . . . . . | $70,720 | . . . . | $53,760 |

(D) *Short taxable years.* A short taxable year is treated as a full 12 months.

(E) *Adjustments to inventory costs from prior years*—(*1*) *General rule*—(*i*) The use of the revaluation factor, based on current costs, to estimate the revaluation of prior inventory layers under the 3-year average method, as described in paragraph (c)(2)(v) of this section, may result in an allocation of costs that include amounts attributable to costs not incurred during the year in which the layer arose. To the extent a taxpayer can demonstrate that costs that contributed to the determination of the revaluation factor could not have affected a prior year, the revaluation factor as applied to that year may be adjusted under the restatement adjustment procedure, as described in paragraph (c)(2)(v)(F) of this section. The determination that a cost could not have affected a prior year must be made by a taxpayer only upon showing that the type of cost incurred during the years used to calculate the revaluation factor (revaluation years) was not present during such prior year. An item of cost will not be eligible for the restatement adjustment procedure simply because the cost varies in amount from year to year or the same type of cost is described or referred to by a different name from year to year. Thus, the restatement adjustment procedure allowed under paragraph (c)(2)(v)(F) of this section is not available in a prior year with respect to a particular cost if the same type of cost was incurred both in the revaluation years and in such prior year, although the amount of such cost and the name or description thereof may vary.

(*ii*) The provisions of this paragraph (c)(2)(v)(E) are also applicable to taxpayers using the weighted average method in revaluing inventories under paragraph (c)(2)(iv) of this section. Thus, to the extent a taxpayer can demonstrate that costs that contributed to the determination of the restatement of a particular year or item could not have affected a prior year or item, the taxpayer may adjust the revaluation of that prior year or item accordingly under the weighted average method. All the requirements and definitions, however, applicable to the restatement adjustment procedure under this paragraph (c)(2)(v)(E) fully apply to a taxpayer using the weighted average method to revalue inventories.

(*2*) *Examples of costs eligible for restatement adjustment procedure.* The provisions of this paragraph (c)(2)(v)(E) are illustrated by the following four examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in the four examples is 1997. The examples read as follows:

*Example 1.* Taxpayer A is a reseller that introduced a defined benefit pension plan in 1994, and made the plan available to personnel whose labor costs were (directly or indirectly) properly allocable to resale activities. A determines the revaluation factor based on data available for the years 1994 through 1996, for which the pension plan was in existence. Based on these facts, the costs of the pension plan in the revaluation years are eligible for the restatement adjustment procedure for years prior to 1994.

*Example 2.* Assume the same facts as in *Example 1,* except that a defined contribution plan was available, during prior years, to personnel whose labor costs were properly allocable to resale activities. The defined contribution plan was terminated before the introduction of the defined benefit plan in 1994. Based on these facts, the costs of the defined benefit pension plan in the revaluation years are not eligible for the restatement adjustment procedure with respect to years for which the defined contribution plan existed.

*Example 3.* Taxpayer C is a manufacturer that established a security department in 1995 to patrol and safeguard its production and warehouse areas used in C's trade or business. Prior to 1995, C had not been required to utilize security personnel in its trade or business; C established the security department in 1995 in response to increasing vandalism and theft at its plant locations. Based on these facts, the costs of the security department are eligible for the restatement adjustment procedure for years prior to 1995.

*Example 4.* Taxpayer D is a reseller that established a payroll department in 1995 to process the company's weekly payroll. In the years 1991 through 1994, D engaged the services of an outside vendor to process the company's payroll. Prior to 1991, D's payroll processing was done by D's accounting department, which was responsible for payroll processing as well as for other accounting functions. Based on these facts, the costs of the payroll department are not eligible for the restatement adjustment procedure. D was incurring the same type of costs in earlier years as D was incurring in the payroll department in 1995 and subsequent years, although these costs were designated by a different name or description.

(F) *Restatement adjustment procedure*—(*1*) *In general*—(*i*) This paragraph (c)(2)(v)(F) provides a restatement adjustment procedure whereunder a taxpayer may adjust the restatement of inventory costs in prior taxable years in order to produce a different restated value than the value that would otherwise occur through application of the revaluation factor to such prior taxable years.

(*ii*) Under the restatement adjustment procedure as applied to a particular prior year, a taxpayer must determine the particular items of cost that are eligible for the restatement adjustment with respect to such prior year. The taxpayer must then recompute, using reasonable estimates and procedures, the total inventoriable costs that would have been incurred for each revaluation year under the taxpayer's former method and the taxpayer's new method by making appropriate adjustments in the data for such revaluation year to reflect the particular costs eligible for adjustment.

(*iii*) The taxpayer must then compute the total percentage change with respect to each revaluation year, using the revised estimates of total inventoriable costs for such year as described in paragraph (c)(2)(v)(F)(1)(ii) of this section. The percentage change must be determined by calculating the ratio of the revised total of the inventoriable costs for such revaluation year under the taxpayer's new method to the revised total of the inventoriable costs for such revaluation year under the taxpayer's former method.

(*iv*) An average of the resulting percentage change for all revaluation years is then calculated, and the resulting average is applied to the prior year in issue.

(2) *Examples of restatement adjustment procedure.* The provisions of this paragraph (c)(2)(v)(F) are illustrated by the following two examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in the two examples is 1997. The examples read as follows:

*Example 1.* Taxpayer A is a reseller that is eligible to make a restatement adjustment by reason of the costs of a defined benefit pension plan that was introduced in 1994, during the revaluation period. The revaluation factor, before adjustment of data to reflect the pension costs, is as provided in the example in paragraph (c)(2)(v)(C) of this section. Thus, for example, with respect to the year 1994, the total inventoriable costs under A's former method is $35,000, the total inventoriable costs under A's new method is $45,150, and the percentage change is .29. Under the method of accounting used by A during 1994 (the former method), none of the pension costs were included as inventoriable costs. Thus, under the restatement adjustment procedure, the total inventoriable cost under A's former method would remain at $35,000 if the pension plan had not been in existence. Similarly, A determines that the total inventoriable costs for 1994 under A's new method, if the pension plan had not been in existence, would have been $42,000. The restatement adjustment for 1994 determined under this paragraph (c)(2)(v)(F) would then be equal to .20 ([$42,000 – $35,000]/$35,000). A would make similar calculations with respect to 1995 and 1996. The average of such amounts for each of the three years in the revaluation period would then be determined as in the example in paragraph (c)(2)(v)(C) of this section. Such average would be used to revalue cost layers for years for which the pension plan was not in existence. Such revalued layers would then be viewed as restated in compliance with the requirements of this paragraph. With respect to cost layers incurred during years for which the pension plan was in existence, no adjustment of the revaluation factor would occur.

*Example 2.* Assume the same facts as in *Example 1,* except that a portion of the pension costs were included as inventoriable costs under the method used by A during 1994 (the former method). Under the restatement adjustment procedure, A determines that the total inventoriable costs for 1994 under the former method, if the pension plan had not been in existence, would have been $34,000. Similarly, A determines that the total inventoriable costs for 1994 under A's new method, if the pension plan had not been in existence, would have been $42,000. The restatement adjustment for 1994 determined under this paragraph (c)(2)(v)(F) would then be equal to .24 ([$42,000 – $34,000]/$34,000). A would make similar calculations with respect to 1995 and 1996. The average of such amounts for each of the three years in the revaluation period would then be determined as in the example in paragraph (c)(2)(v)(C) of this section. Such average would be used to revalue cost layers for years for which the pension plan was not in existence.

(3) *Intercompany items*—(i) *Revaluing intercompany transactions.* Pursuant to any change in method of accounting for costs subject to section 263A, taxpayers are required to revalue the amount of any intercompany item resulting from the sale or exchange of inventory property in an intercompany transaction to an amount equal to the intercompany item that would have resulted had the cost of goods sold for that inventory property been determined under the taxpayer's new method. The requirement of the preceding sentence applies with respect to both inventory produced by a taxpayer and inventory acquired by the taxpayer for resale. In addition, the requirements of this paragraph (c)(3) apply only to any intercompany item of the taxpayer as of the beginning of the year of change in method of accounting. See §1.1502–13(b)(2)(ii). A taxpayer must revalue the amount of any intercompany item only if the inventory property sold in the intercompany transaction is held as inventory by a buying member as of the date the taxpayer changes its method of accounting under section 263A. Corresponding changes to the adjustment required under section 481(a) must be made with respect to any adjustment of the intercompany item required under this paragraph (c)(3). Moreover, the requirements of this paragraph (c)(3) apply regardless of whether the taxpayer has any items in beginning inventory as of the year of change in method of accounting. See §1.1502–13 for the definition of intercompany transaction.

(ii) *Example.* The provisions of this paragraph (c)(3) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. (i) Assume that S, a member of a consolidated group filing its federal income tax return on a calendar year, manufactures and sells inventory property to B, a member of the same consolidated group, in 1996. The sale between S and B is an intercompany transaction as defined under §1.1502–13(b)(1). The gain from the intercompany transaction is an intercompany item to S under §1.1502–13(b)(2). As of the beginning of the year of change in method of accounting (January 1, 1997), the inventory property is still held by B based on the particular inventory method of accounting used by B for federal income tax purposes (for example, the LIFO or FIFO inventory method). The property was sold by S to B in 1996 for $150; the cost of goods sold with respect to the property under the method in effect at the time the inventory was produced was $100, resulting in an intercompany item of $50 to S under §1.1502–13. As of January 1, 1997, S still has an intercompany item of $50.

(ii) S is required to revalue the amount of its intercompany item to an amount equal to what the intercompany item would have been had the cost of goods sold for that inventory property been determined under S's new method. Assume that the cost of the inventory under this method would have been $110, had the method applied to S's manufacture of the property in 1996. Thus, S is required to revalue the amount of its intercompany item to $40 (that is, $150 less $110), necessitating a negative adjustment to the intercompany item of $10. Moreover, S is required to increase its adjustment under section 481(a) by $10 in order to prevent the omission of such amount by virtue of the decrease in the intercompany item.

(iii) *Availability of revaluation methods.* In revaluing the amount of any intercompany item resulting from the sale or exchange of inventory property in an intercompany transaction to an amount equal to the intercompany item that would have resulted had the cost of goods sold for that inventory property been determined under the taxpayer's new method, a taxpayer may use the other methods and procedures otherwise properly available to that particular taxpayer in revaluing inventory under section 263A and the regulations thereunder, including, if appropriate, the various simplified methods provided in section 263A and the regulations thereunder and the various procedures described in this paragraph (c).

(4) *Anti-abuse rule*—(i) *In general.* Section 263A(i)(1) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 263A, including regulations to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of section 263A and the regulations thereunder. One way in which the application of section 263A and the regulations thereunder would be otherwise avoided is through the use of entities described in the preceding sentence in such a manner as to effectively avoid the necessity to restate beginning inventory balances under the change in method of accounting required or permitted under section 263A and the regulations thereunder.

(ii) *Deemed avoidance of this section*—(A) *Scope.* For purposes of this paragraph (c), the avoidance of the application of section 263A and the regulations thereunder will be deemed to occur if a taxpayer using the LIFO method of accounting for inventories, transfers inventory property to a related corporation in a transaction described in section 351, and such transfer occurs:

(*1*) On or before the beginning of the transferor's taxable year beginning in 1987; and

(*2*) After September 18, 1986.

(B) *General rule.* Any transaction described in paragraph (c)(4)(ii)(A) of this section will be treated in the following manner:

(*1*) Notwithstanding any provision to the contrary (for example, section 381), the transferee corporation is required to revalue the inventories acquired from the transferor under the provisions of this paragraph (c) relating to the change in method of accounting and the adjustment required by section 481(a), as if the inventories had never been transferred and were still in the hands of the transferor; and

(**2**) Absent an election as described in paragraph (c)(4)(iii) of this section, the transferee must account for the inventories acquired from the transferor by treating such inventories as if they were contained in the transferee's LIFO layer(s).

(iii) *Election to use transferor's LIFO layers.* If a transferee described in paragraph (c)(4)(ii) of this section so elects, the transferee may account for the inventories acquired from the transferor by allocating such inventories to LIFO layers corresponding to the layers to which such properties were properly allocated by the transferor, prior to their transfer. The transferee must account for such inventories for all subsequent periods with reference to such layers to which the LIFO costs were allocated. Any such election is to be made on a statement attached to the timely filed federal income tax return of the transferee for the first taxable year for which section 263A and the regulations thereunder applies to the transferee.

(iv) *Tax avoidance intent not required.* The provisions of paragraph (c)(4)(ii) of this section will apply to any transaction described therein, without regard to whether such transaction was consummated with an intention to avoid federal income taxes.

(v) *Related corporation.* For purposes of this paragraph (c)(4), a taxpayer is related to a corporation if—

(A) the relationship between such persons is described in section 267(b)(1), or

(B) such persons are engaged in trades or businesses under common control (within the meaning of paragraphs (a) and (b) of section 52).

(d) *Non-inventory property*—(1) *Need for adjustments.* A taxpayer that changes its method of accounting for costs subject to section 263A with respect to non-inventory property must revalue the non-inventory property on hand at the beginning of the year of change as set forth in paragraph (d)(2) of this section, and compute an adjustment under section 481(a). The adjustment under section 481(a) will equal the difference between the adjusted basis of the property as revalued using the taxpayer's new method and the adjusted basis of the property as originally valued using the taxpayer's former method.

(2) *Revaluing property.* A taxpayer must revalue its non-inventory property as of the beginning of the year of change in method of accounting. The facts and circumstances revaluation method of paragraph (c)(2)(iii) of this section must be used to revalue this property. In revaluing non-inventory property, however, the only additional section 263A costs that must be taken into account are those additional section 263A costs incurred after the later of December 31, 1986, or the date the taxpayer first becomes subject to section 263A, in taxable years ending after that date. See §1.263A–1(d)(3) for the definition of additional section 263A costs.

*§ 1.263A–7T [Removed]*

Par. 5. Section 1.263A–7T is removed.

*§ 1.263A-15 [Amended]*

Par. 6. Section 1.263A–15 is amended by removing "1.263A–7T (e) generally" from the last sentence in paragraph (a)(1) and replacing it with "1.263A–7".

Michael P. Dolan,
*Acting Commissioner of Internal Revenue.*

Approved July 28, 1997.

Donald C. Lubick,
*Acting Assistant Secretary of the Treasury.*

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