Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Michael E. Lueck
Attorney
(CC:LM:HMT:DET)

from: Thomas Luxner
Branch Chief, Branch 6
(Income Tax & Accounting)

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subject: **Application of section 1.263A-7(d).**

This Chief Counsel Advice responds to your request for assistance dated December 3, 2003. This advice may not be used or cited as precedent.

ISSUES

1. Whether a taxpayer that is changing its method of accounting for costs subject to § 263A of the Internal Revenue Code with respect to non-inventory property may revalue such property using the 3-year average method described in § 1.263A-7(c)(2)(v) of the Income Tax Regulations.

2. Whether a taxpayer that is changing its method of accounting for costs subject to § 263A with respect to non-inventory property may use a 3-year average, similar to the 3-year average method described in § 1.263A-7(c)(2)(v), as a reasonable estimate and procedure when using the facts and circumstances method provided by § 1.263A-7(c)(2)(iii).

3. Whether a taxpayer that is changing its method of accounting for costs subject to § 263A with respect to non-inventory property may use the exception provided in § 1.263A-7(c)(2)(iii)(B).

CONCLUSIONS

1. A taxpayer changing its method of accounting for costs subject to § 263A (UNICAP) with respect to non-inventory property is not permitted to use the 3-year average method described in § 1.263A-7(c)(2)(v). Instead, a taxpayer that

changes its method of accounting for costs subject to § 263A with respect to non-inventory property must use the facts and circumstances method described in § 1.263A-7(c)(2)(iii).

2. A taxpayer changing its method of accounting for costs subject to § 263A with respect to non-inventory property may use a 3-year average, similar to the 3-year average method described in § 1.263A-7(c)(2)(v), as a reasonable estimate and procedure when using the facts and circumstances method provided certain conditions are satisfied. The facts and circumstances method contemplates the use of reasonable estimates and procedures provided two requirements are met. First, the taxpayer must lack, and be unable to reconstruct from its books and records, actual financial and accounting data that is required to apply the capitalization rules of § 263A to the relevant facts and circumstances. Second, the total amounts of cost for which reasonable estimates and procedures are employed must not be 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. A taxpayer that is permitted to use reasonable estimates and procedures may use available information from more recent years to estimate the amount and nature of costs applicable to earlier years. However, the taxpayer must demonstrate to the satisfaction of the director that the 3 years it is using are representative of its prior years and, therefore, reasonable.

3. A taxpayer changing its method of accounting for costs subject to § 263A with respect to non-inventory property may not use the exception provided by § 1.263A-7(c)(2)(iii)(B). The exception provided by this section only applies to the revaluation of inventory.

FACTS[1]

Taxpayer produces self-constructed assets (non-inventory property) for use in its trade or business. These self-constructed assets are subject to § 263A. Taxpayer accounts for these assets as fixed assets and recovers the costs to produce them over the recovery period provided in §§ 167 and 168 and the regulations thereunder. Taxpayer has requested consent to change its method of accounting for costs subject to § 263A with respect to such non-inventory property. As part of its request, the taxpayer has proposed to make a § 481(a) adjustment. Taxpayer computed the proposed § 481(a) adjustment using the 3-year average method described in § 1.263A-7(c)(2)(v).

LAW AND ANALYSIS

Section 1.263A-7 provides guidance to taxpayers changing their methods of accounting for costs subject to § 263A. In particular, this section provides guidance

[1] The above facts are hypothetical and have been assumed to further the analysis of the issues presented.

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 § 263A.

Section 1.263A-7(c) provides that when a taxpayer changes its method of accounting for costs subject to § 263A with respect to inventory property, the taxpayer generally must, in computing its taxable income for the year of change, take into account a § 481(a) adjustment. The adjustment required by section 481(a) relates to the revaluation of the taxpayer's inventory and is equal to the difference between the inventory as originally valued under the former method and the inventory as revalued using the new method. The regulation further provides the following three methods to revalue inventory: the facts and circumstances method, the weighted average method, and the 3-year average method. The facts and circumstances method provided by § 1.263A-7(c)(2)(iii) may be used by any taxpayer changing its method of accounting for costs subject to § 263A with respect to inventory regardless of its inventory identification method. A taxpayer changing its method of accounting for costs subject to § 263A with respect to inventory may use the weighted average method provided by § 1.263A-7(c)(2)(iv) if it uses either the first-in, first-out (FIFO) or the specific goods last-in, first-out (LIFO) inventory method. A taxpayer changing its method of accounting for costs subject to § 263A with respect to inventory may use the 3-year average method provided by § 1.263A-7(c)(2)(v) if it uses the dollar-value LIFO inventory method.

Section 1.263A-7(c)(2)(iii) provides that under the facts-and-circumstances method, a taxpayer generally is required to revalue its inventories by applying the capitalization rules of § 263A and the regulations thereunder to its production and resale activities, with the same degree of specificity as required of inventory manufacturers immediately prior to the effective date of UNICAP. However, this method permits a taxpayer to utilize reasonable estimates and procedures in valuing inventory if: (1) the taxpayer lacks, and is unable to reconstruct from its books and records, actual financial and accounting data, 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 of the items or costs for the period in question. Taxpayers permitted to use reasonable estimates and procedures under the facts and circumstances revaluation method may either: (1) use available information from more recent years to estimate the amount and nature of inventory costs applicable to earlier years or (2) use available information with respect to comparable items produced or acquired during the same year in order to estimate the costs associated with other items.

Section 1.263A-7(c)(2)(iii)(B) provides that a taxpayer using the facts and circumstances method to revalue its inventory who is not permitted to use reasonable estimates and procedures because of the existence of a significant amount of costs, is required to use the weighted average method or the 3-year average method.

Section 1.263A-7(c)(2)(iv) provides that taxpayers using the FIFO method or the specific goods LIFO method to account for their inventories may use the weighted average method to revalue their inventories. This section further provides that the weighted average method is only available to a taxpayer if it lacks sufficient data to revalue its inventory costs under the facts and circumstances revaluation method. Moreover, a taxpayer that is permitted to use the weighted average method may only use such method to revalue 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 use such method. Under the weighted average method, an item in ending inventory is revalued 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 is revalued 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.

Section 1.263A-7(c)(2)(v) provides that a taxpayer using the dollar-value LIFO method to account for inventory may use the 3-year average method to revalue existing LIFO layers when changing its method of accounting for costs subject to § 263A with respect to such inventory. The 3-year average method is based on the average percentage change 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 average method is available to a dollar-value LIFO taxpayer regardless of whether the taxpayer lacks sufficient data to revalue its inventory costs under the facts and circumstances revaluation method.

Section 1.263A-7(d) provides that taxpayers that change their method of accounting for costs subject to § 263A with respect to non-inventory property must revalue the non-inventory property on hand at the beginning of the year of change and compute an adjustment under § 481(a). The adjustment under § 481(a) is equal to 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. Moreover, the regulation provides that a taxpayer must revalue the non-inventory property using the facts and circumstances method provided for inventory changes (i.e., § 1.263A-7(c)(2)(iii)).

Rev. Proc. 2002-9, 2002-1 C.B. 327, modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432, provides the procedures by which a taxpayer may obtain automatic consent to change the methods of accounting described in the Appendix of the revenue procedure.

Section 9 of Rev. Proc. 2002-9, 2002-1 C.B. 327, 344, provides that the director must apply a change in method of accounting made in compliance with all the applicable provisions of the revenue procedure in determining the taxpayer’s liability, unless the director recommends that the change in method of accounting be modified or revoked. The director’s examination of whether the change in accounting method is in compliance with the revenue procedure includes whether the amount of the § 481(a) adjustment was properly determined. The director may adjust the taxpayer's § 481(a) adjustment if he determines that it has not been properly computed.

Rev. Proc. 97-27, 1997-1 C.B. 680, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, provides the general procedures under § 446(e) and § 1.446-1(e) for obtaining the consent of the Commissioner to change a method of accounting.

Section 11 of Rev. Proc. 97-27 provides that in determining the taxpayer's liability the director will ascertain if the amount of the § 481(a) adjustment was properly determined. If the director determines that the § 481(a) adjustment should be modified, he is not required to forward such matter to the national office for consideration.

In your request for advice, you ask whether taxpayers may use the 3-year average method described in § 1.263A-7(c)(2)(v) to revalue non-inventory property. Alternatively, you question whether taxpayers revaluing non-inventory property are entitled to use a 3-year average method because the facts and circumstances revaluation method permits the use of reasonable estimates and procedures. You also question whether taxpayers revaluing non-inventory property that fail to satisfy the criteria to use reasonable estimates and procedures under the facts and circumstances revaluation method may use the exception provided in § 1.263A-7(c)(2)(iii)(B).

A taxpayer that changes its method of accounting for costs subject to § 263A with respect to non-inventory property is not permitted to use the 3-year average method described in § 1.263A-7(c)(2)(v). Section 1.263A-7(d) provides the rules for revaluing non-inventory property when a taxpayer changes its method of accounting for costs subject to § 263A with respect to non-inventory property. This section provides that a taxpayer changing its method of accounting for costs subject to § 263A with respect to non-inventory property must use the facts and circumstances method described in § 1.263A-7(c)(2)(iii), not the 3-year average method provided by § 1.263A-7(c)(2)(v). Moreover, section 1.263A-7(c)(2)(v) clearly indicates that the 3-year average method is only applicable to a taxpayer that is changing its method of accounting for costs subject to § 263A with respect to inventory if the taxpayer uses the dollar-value LIFO method to account for such inventory. Accordingly, the hypothetical taxpayer in this case may not use the 3-year average method provided by § 1.263A-7(c)(2)(v) to revalue its non-inventory property.

A taxpayer changing its method of accounting for costs subject to § 263A with respect to non-inventory property may use a 3-year average, similar to the 3-year average method described in § 1.263A-7(c)(2)(v), as a reasonable estimate and procedure in using the facts and circumstances method provided certain conditions are satisfied.

Section 1.263A-7(c)(2)(iii) provides that a taxpayer is permitted to use reasonable estimates and procedures to revalue inventory under the facts and circumstances revaluation method 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 § 263A to the relevant facts and circumstances surrounding a particular item or cost, and (2) the total amounts 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. The request for advice does not provide any hypothetical facts to determine whether the total amounts for which reasonable estimates and procedures are being employed are significant. Moreover, such a determination is factual and, therefore, normally a proper determination for the examination function.

Assuming arguendo that a taxpayer is permitted to use reasonable estimates and procedures under the facts and circumstances revaluation method, the taxpayer would be required to demonstrate that the estimates and procedures it is using are reasonable. For example, if a taxpayer uses available information from its most recent 3 taxable years to estimate the amount of non-inventory property costs applicable to earlier taxable years, the taxpayer is required to demonstrate that the information from such 3 taxable years is representative of its earlier taxable years. The taxpayer's use of its most recent 3 taxable years to estimate the amount of non-inventory property costs applicable to its earlier taxable years would not be reasonable if the 3 taxable years used are not representative of the taxpayer's prior taxable years.

A taxpayer changing its method of accounting for costs subject to § 263A with respect to non-inventory property may not use the exception provided by § 1.263A-7(c)(2)(iii)(B). This section provides that a taxpayer that is unable to use the facts and circumstances revaluation method to revalue its inventory without using reasonable estimates and procedures, and that is unable to use reasonable estimates and procedures because of the existence of significant amounts of costs that would require the use of reasonable estimates and procedures, must revalue its inventory under either the weighted average method or the 3-year average method.

Taxpayers that are required to revalue non-inventory property under § 1.263A-7(d) are not permitted to use either the weighted average method provided by § 1.263A-7(c)(2)(iv) or the 3-year average method provided by § 1.263A-7(c)(2)(v) to make such revaluation. Instead, § 1.263A-7(d) specifically provides that a taxpayer changing its method of accounting for costs subject to § 263A with respect to non-inventory property <u>must</u> use the facts and circumstances revaluation method. This section of the regulation does not provide any exceptions. In other words, the precise language of the section does not provide any indication that the exception provided by § 1.263A-7(c)(2)(iii)(B) was meant to apply to the revaluation of non-inventory property. Instead, a close reading indicates that such exception was meant to only apply to the revaluation of inventory.

Conversely, the regulation provides three methods to revalue inventory when a taxpayer changes its method of accounting for costs subject to § 263A with respect to inventory. None of these methods for revaluing inventory refer to the revaluation of non-inventory property. Instead, each method specifically limits its application to inventory. Moreover, two of the methods, the weighted average method and the 3-year average method, limit their application to taxpayers that are using a specified inventory method (i.e., FIFO, specific goods LIFO, or dollar-value LIFO). In particular, the 3-year average method is only available to a taxpayer changing its method of accounting for costs subject to § 263A relating to inventory if the taxpayer uses the dollar-value LIFO inventory method. Thus, the 3-year average method is not available to a taxpayer that uses either the FIFO or the specific goods LIFO methods to account for its inventory. Similarly, the 3-year average method is not available to a taxpayer that is changing its method of accounting for costs subject to § 263A related to non-inventory property.

The weighted average method and the 3-year average methods were provided by the Treasury Department upon the urging of Congress to provide taxpayers with inventory estimation methods to compute their § 481(a) adjustments. The legislative history of § 263A clearly indicates that Congress preferred that a taxpayer changing its method of accounting for costs subject to § 263A revalue its property on hand at the beginning of the year using a facts-and-circumstances method. However, Congress realized that information to compute an accurate § 481(a) adjustment using a facts-and-circumstances method may not be available where a taxpayer was holding inventory that was acquired or produced a number of years prior to the year of change. See H.R. Rep. No. 426, 99th Cong., 1st Sess. 633-37 (1985), 1986-3 (Vol. 2) C.B. 633-37 and S.Rep. No. 313, 99th Cong., 2nd Sess. 147-52 (1986), 1986-3 (Vol. 3) C.B. 147-52. In particular, Congress was concerned that where a taxpayer is considered holding inventory items that were either acquired for resale, produced, or manufactured a number of years prior to the effective date of § 263A, the taxpayer may not have available the necessary information to compute a § 481(a) adjustment using the facts-and-circumstances approach. Moreover, Congress specifically recognized that taxpayers using the LIFO method might have difficulty in assembling sufficient data to restate inventory costs because the valuation of each year's LIFO layer is dependent upon prior years cost data when the double extension method is used. Accordingly, Congress expected that the Treasury Department would issue regulations or rulings that would permit taxpayers in these situations to estimate the amount of their revalued inventory using available data. Moreover, the conference reports underlying the enactment of § 263A specifically suggest that the Treasury Department should permit the use of a weighted average method for taxpayers accounting for their inventories under the FIFO or specific goods LIFO methods and the use of a 3-year average method for taxpayers accounting for their inventories under the dollar-value LIFO method.

On the other hand, Congress did not express such a desire to permit estimates when a taxpayer was changing its method of accounting for costs subject to § 263A with respect to non-inventory property. Instead, Congress specifically provided that § 263A would generally only apply to costs related to the production of self-constructed assets that were incurred after December 31, 1986. See Tax Reform Act of 1986, § 803(d), 1986-3 (Vol. 1) C.B. 1, 273. Accordingly, taxpayers are generally not required to re-compute the value of non-inventory property that was produced prior to such date.

Therefore, Congress did not provide for the use of estimates with regard to non-inventory property.

Under both Rev. Proc. 2002-9 (the automatic consent procedures for changes in accounting method) and Rev. Proc. 97-27 (the advance consent procedures for changes in accounting method), the director ascertains whether the amount of the § 481(a) adjustment is proper and can make any necessary adjustments. Accordingly, if a taxpayer uses estimates and procedures to compute a § 481(a) adjustment with regard to a change in method of accounting for costs subject to § 263A for non-inventory property when it is not permitted to do so, the director may make an appropriate adjustment to the taxpayer's § 481(a) adjustment. It may be appropriate for the director to modify the adjustment to reflect a cut-off method if the taxpayer has not maintained sufficient records to compute a proper § 481(a) adjustment. Compare for example section 5.04(2) of Rev. Proc. 2002-18, 2002-1 C.B. 678. Rev. Proc. 2002-18 provides procedures for changes in method of accounting imposed by the Service.

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