INTERNAL REVENUE SERVICE
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CASE MIS No.: TAM-102004-00/CC:ITA:b7

District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:
Date of Conference:

LEGEND:

A% =
B% =
C% =
D% =
X =
Y =

ISSUE:

Did the taxpayer, which changed from one method of accounting under § 263A of the Internal Revenue Code to another method of accounting under § 263A, properly revalue its inventories to reflect its change in method of accounting?

CONCLUSION:

No. The taxpayer's method of revaluing its inventory, which was modeled upon the 3-year average method in § 1.263A-7T, was not authorized by § 1.263A-7T and was not a reasonable revaluation method under the principles of §§ 446 and 481.

FACTS:

The taxpayer, an operator of is the parent corporation of an affiliated group that files consolidated federal income tax returns. The taxpayer uses an overall accrual method of accounting. Inventories for all departments except Y are maintained using a dollar value, last-in, first-out (LIFO) method; inventories for the Y department are maintained on a first-in, first-out (FIFO) basis. LIFO inventories are computed using a method with price indexes.

For its taxable year beginning in 1988, the taxpayer changed its method of accounting to conform with § 263A. Under this method, the taxpayer used the simplified resale method without an historic absorption ratio to allocate § 263A costs to ending inventory. Capitalizable mixed service costs were determined under the simplified service cost method with a labor based allocation ratio.

In 1994, taxpayer obtained automatic consent under Rev. Proc. 94-49, 1994-2 C.B. 705, to change its method of accounting for vendor discounts under § 263A. The taxpayer utilized the 3-year average method, discussed in detail below, to revalue its inventories and compute its adjustment under § 481(a).

For its taxable year beginning in 1996 (“year of change”), the taxpayer obtained advance consent to change three aspects of its treatment of costs under § 263A. First, costs attributable to the department, which previously had been treated as mixed service costs, were treated as deductible expenses. Second, costs attributable to the department, which previously had been allocated exclusively to resale activities, were treated as mixed service costs. Third, the which had been capitalized under § 263A, recovered through depreciation, and treated as a mixed service cost, was capitalized under § 263A and recovered through depreciation without treatment as a mixed service cost.

The method of accounting used by the taxpayer to account for its inventories immediately prior to its initial adoption of a UNICAP method of accounting in 1988 will be referred to as the taxpayer’s “pre-UNICAP method.” The method of accounting used by the taxpayer to account for its inventories immediately prior to the year of change will be referred to as the taxpayer’s “old UNICAP method.” The method of accounting for inventories to which the taxpayer changed in its year of change will be referred to as the taxpayer’s “new UNICAP method.”

Taxpayer revalued its inventories on hand as of the first day of the year of change under its new UNICAP method. The difference between the ending inventory on the final day of the taxable year preceding the year of change (valued under the old UNICAP method) and the beginning inventory on the first day of the year of change (valued under the new UNICAP method) was taken into account as an adjustment under § 481(a). The taxpayer and the examiner agree that the difference in the values of the inventory under the old UNICAP method and the new UNICAP method represents the § 481(a) adjustment, but disagree on how to revalue the inventories.

<u>Taxpayer’s revaluation of its inventory</u>

The taxpayer purports to use the 3-year average method to revalue its inventories under its new UNICAP method. See §§ 1.263A-7T(e)(6)(iv)(A), 1.263A-7(c)(2)(v)(A). The 3-year average method is a simplified method that allows a dollar-value LIFO taxpayer to revalue its LIFO increments for all years based upon three sample years. A "3-year revaluation factor" is computed that represents the weighted average percentage change in the current costs of inventory from the old accounting method to the new accounting method during the three sample years. All increments of the inventory are then multiplied by the 3-year revaluation factor to determine the new inventory valuation.

The taxpayer's application of the 3-year average method, and the examiner's objections thereto, will be illustrated using hypothetical inventory data in order to simplify the presentation of the issues and to preserve the confidentiality of the taxpayer's data. Specifically, we will assume that, at the end of the taxable year preceding the year of change, the taxpayer's LIFO inventory was comprised as follows:

TABLE 1: TAXPAYER'S HYPOTHETICAL INVENTORY

(A) Year	(B) Pre-UNICAP method – base year costs	(C) Index	(D) Pre-UNICAP method – current year costs	(E) Old UNICAP method – absorption ratio	(F) Old UNICAP method – carrying value
Base	$500,000	1.00	$500,000	10.0%	$550,000
1991	45,000	1.10	49,500	9.5%	54,203
1992	55,000	1.20	66,000	9.0%	71,940
1993	45,000	1.30	58,500	8.5%	63,473
1994	5,000	1.40	7,000	8.0%	7,560
1995	35,000	1.50	52,500	7.5%	56,438
	$685,000		$733,500		$803,614

In applying the 3-year average method to revalue its inventory, the taxpayer first calculates the actual UNICAP absorption ratio under its new method of accounting for each of the three years in its sample period, namely 7.5% for 1993, 6.5% for 1994 and 6.0% for 1995. (See Column D in Table 2, below.) Using these ratios, the taxpayer calculates the actual additional § 263A costs attributable to these increments under the new UNICAP method – $4,388 for 1993, $455 for 1994 and $3,150 for 1995. (See Column E in Table 2, below).

TABLE 2: CALCULATION OF REVALUATION FACTOR

	(A)	(B)	(C = A x B)	(D)	(E = A x D)
	Pre-UNICAP method – increment	Old UNICAP method -- absorption ratio	Old UNICAP method – additional § 263A costs	New UNICAP method – absorption ratio (actual)	New UNICAP method – additional § 263A costs
1993	$ 58,500	8.5%	$ 4,973	7.5%	$ 4,388
1994	$ 7,000	8.0%	$ 560	6.5%	$ 455
1995	$ 52,500	7.5%	$ 3,938	6.0%	$ 3,150
TOTALS	$ 118,000		$ 9,471		$ 7,993
			$ 118,000		$ 118,000
			$ 127,471		$ 125,993

Second, the taxpayer calculates an average absorption ratio under the new UICAP method (the "new UNICAP method average absorption ratio"). This ratio is calculated by dividing the total additional § 263A costs under the new UNICAP method for the 1993, 1994 and 1995 increments ($7,993) by the total pre-UNICAP increments for such years ($118,000).

$$\frac{\$\ 7{,}993}{\$\ 118{,}000} = 6.774\% = \text{new UNICAP method average absorption ratio}$$

Third, the taxpayer revalues its inventory by substituting the new UNICAP method average absorption ratio (6.774%) for the existing old UNICAP method absorption ratio for each increment. Table 3, below, shows the old UNICAP method absorption ratios, the new UNICAP method average absorption ratio, and the percent change in the absorption ratios for each year.

TABLE 3: TAXPAYER REVALUATION – UNICAP ABSORPTION RATIOS

	(A) Old UNICAP method – absorption ratio	(B) New UNICAP method – actual absorption ratio	(C) New UNICAP method – average absorption ratio (taxpayer's 3-year method calculation)	(D) % Change from A to C (= [C-A] / A)
BASE	10.0%		6.774%	-32%
1991	9.5%		6.774%	-29%
1992	9.0%		6.774%	-25%
1993	8.5%	7.5%	6.774%	-20%
1994	8.0%	6.5%	6.774%	-15%
1995	7.5%	6.0%	6.774%	-10%

Thus, the base year increment, which had an absorption ratio of 10.0% under the old UNICAP method (column A), is revalued by substituting the new UNICAP method average absorption ratio of 6.774% (column C), which is approximately 32% less (column D) than the absorption ratio under the old UNICAP method. Similarly, the 1995 increment, which had an absorption ratio of 7.5% under the old UNICAP method and would have an actual absorption ratio of 6.0% under the new UNICAP method (column B), is revalued by substituting the new UNICAP method average absorption ratio of 6.774%, which is only 10% less than the absorption ratio under the old UNICAP method.

The examiner raises four principal objections to the taxpayer's method of revaluing its inventory under its new UNICAP method: (i) the taxpayer improperly computed its revaluation factor with reference to its pre-UNICAP method rather than its old UNICAP method; (ii) the taxpayer improperly revalued increments without reference to their absorption ratios under its old UNICAP method; (iii) the taxpayer improperly computed its revaluation factor using the current cost of inventory increments rather than total current costs; and (iv) the taxpayer used an improper procedure to determine its § 481(a) adjustment. Each objection will be discussed in turn.

First objection: use of pre-UNICAP method in revaluation of inventory

First, the examiner contends that the inventory revaluation is erroneous because the two methods of accounting upon which the taxpayer bases its revaluation (the pre-UNICAP method and the new UNICAP method) are different from the two methods of accounting that are involved in the change (the old UNICAP method and the new UNICAP method). A proper revaluation of the taxpayer's inventory, the examiner argues, should be based upon a comparison of the two methods of accounting actually involved in the change: the old UNICAP method (prior method) and the new UNICAP method (new method).

Second objection: substitution of new UNICAP method average absorption ratio for old UNICAP method absorption ratios

The examiner next argues that the taxpayer's revaluation is improper because the taxpayer recomputes the additional § 263A costs under the new UNICAP method by substituting the same absorption ratio – the new UNICAP method average absorption ratio – for every increment, without any regard to the existing absorption ratios of the various increments under the old UNICAP method. The examiner urges that the additional § 263A costs under the new UNICAP method should be computed by using the 3-year revaluation factor to adjust the old UNICAP method absorption ratios of each increment individually.

The differences between the taxpayer and the examiner can best be illustrated by a step-by-step comparison of their methodologies.[1]

TABLE 2: CALCULATION OF REVALUATION FACTOR

	(A)	(B)	(C = A x B)	(D)	(E = A x D)
	Pre-UNICAP increment	Old UNICAP method -- absorption ratio	Old UNICAP method – additional § 263A costs	New UNICAP method – absorption ratio (actual)	New UNICAP method – additional § 263A costs
1993	$ 58,500	8.5%	$ 4,973	7.5%	$ 4,388
1994	$ 7,000	8.0%	$ 560	6.5%	$ 455
1995	$ 52,500	7.5%	$ 3,938	6.0%	$ 3,150
TOTALS	$ 118,000		$ 9,471		$ 7,993
			$ 118,000		$ 118,000
			$ 127,471		$ 125,993

The taxpayer and the examiner extract different types of revaluation information from the three-year sample period. As discussed above, the taxpayer calculates a new UNICAP method average absorption ratio of 6.774% by dividing the total additional § 263A costs under the new UNICAP method for the 1993, 1994 and 1995 increments ($7,993) by the total pre-UNICAP increments for such years ($118,000).

[1]To enhance the simplicity of the illustration and the comparability of the alternative calculations, the illustration is based on the increment data used by the taxpayer. As discussed below, however, the examiner argues that the revaluation calculations should be based upon annual current costs, rather than annual increments, from the three-year sample period, and the examiner does the calculation on this basis in the writeup.

The examiner, however, calculates the revaluation factor to reflect the proportionate difference between cost capitalization under the old UNICAP method and cost capitalization under the new UNICAP method. This revaluation factor is calculated by dividing the total of additional § 263A costs capitalized to the 1993, 1994 and 1995 increments under the new UNICAP method ($7,993) by the total of such costs under the old UNICAP method ($9,471).

TAXPAYER	EXAMINER
new UNICAP method average absorption ratio	revaluation factor
$\frac{\$7{,}993}{\$118{,}000} = 6.774\%$	$\frac{\$7{,}993}{\$9{,}471} = .844$

The taxpayer and examiner apply these concepts in very different ways. The taxpayer substitutes the new UNICAP method average absorption ratio for the existing old UNICAP method absorption ratio in every increment of the inventory.[2] The examiner would apply the revaluation factor to the existing UNICAP absorption ratio for each increment to determine the new absorption ratio for that increment. These differences are summarized in Table 4, below.

TABLE 4: TAXPAYER & EXAMINER TREATMENT OF ABSORPTION RATIOS

	(A) Old UNICAP method -- absorption ratio	(B) New UNICAP method – absorption ratio (actual)	**(C) Taxpayer revaluation – average absorption ratio substituted**	(D) Examiner revaluation – revaluation factor	**(E = A x D) Examiner revaulation – absorption ratio revalued**
BASE	10.0%		**6.774%**	.844	**8.44%**
1991	9.5%		**6.774%**	.844	**8.018%**
1992	9.0%		**6.774%**	.844	**7.596%**
1993	8.5%	7.5%	**6.774%**	.844	**7.174%**
1994	8.0%	6.5%	**6.774%**	.844	**6.752%**
1995	7.5%	6.0%	**6.774%**	.844	**6.33%**

[2] We note that the taxpayer apparently did not follow this same procedure – substituting a single UNICAP absorption ratio for all existing increments – when it used the 3-year average method to revalue its inventory in connection with the previous 1994 UNICAP change. Details of how the taxpayer implemented the 3-year average method in connection with the 1994 change in method of accounting are not known.

Thus, the taxpayer revalues the base year increment by substituting the new UNICAP method average absorption ratio of 6.774% (column C) for the old UNICAP method absorption ratio of 10.0% (column A). The examiner would revalue the same increment by applying the revaluation factor of .844 – representing the 3-year average change in § 263A cost capitalization – against the old UNICAP method absorption ratio of 10.0% (column A), which generates the new UNICAP absorption ratio of 8.44% (column E).

The calculation advocated by the taxpayer results in a larger reduction to the inventory value, and thus a greater negative adjustment under § 481(a), than the calculation urged by the examiner. The difference between the two calculations is particularly large for increments in earlier years when the taxpayer's old UNICAP method absorption ratios were as high as 10.0%. The taxpayer's calculation effectively replaces the higher absorption ratios for those years with the considerably lower new UNICAP method average absorption ratio of 6.774%.

Third objection: current cost of increments versus total current costs

The examiner's third objection is that the taxpayer calculates its inventory revaluation on the basis of average change in the current cost of inventory increments of the three taxable years preceding the year of change, rather than the average change in the total current costs of inventory for those years.

For an illustration of this distinction, see the example of a 3-year average method calculation in § 1.263A-7(c)(2)(v)(C). In the calculation of the revaluation factor in § 1.263A-7(c)(2)(v)(C)(ii), the amount for the year 1996 is $54,400, which represents the total current costs in inventory for the year 1996, rather than $5,000, which is the 1996 LIFO increment as shown in § 1.263A-7(c)(2)(v)(C)(i).

Fourth objection: § 481(a) calculation for increments

The examiner's fourth objection is that the taxpayer uses an erroneous procedure to determine the amount of § the 481(a) adjustment attributable to the various increments.

As discussed above, the taxpayer revalues its inventory by substituting the new UNICAP method average absorption ratio of 6.774% for the existing old UNICAP method absorption ratio of each inventory increment . For example, the 1993 increment has an absorption ratio of 8.5% and a value of $63,473 under the old UNICAP method. The taxpayer revalues the increment by substituting the new UNICAP method average absorption ratio of 6.774%, which results in an increment value of $62,463 under the new UNICAP method. The difference between the values of the increment under the old UNICAP method ($63,473) and the new UNICAP method ($62,463) equals the § 481(a) adjustment ($1,010).

The taxpayer, however, determines the § 481(a) adjustment for each increment using an alternate procedure in which the percentage point difference (-1.726%) between the new UNICAP absorption ratio (6.774%) and the old UNICAP method absorption ratio (8.5%) is multiplied against the value of the increment under the old UNICAP method. The examiner contends that the percentage point difference between the two ratios should be multiplied against the value of the increment under the pre-UNICAP method.

The differences between the calculations urged by the taxpayer and the examiner are summarized in Table 5 below, again using the 1993 increment as the example:

TABLE 5: § 481(a) ADJUSTMENT FOR 1993 INCREMENT – TAXPAYER'S METHOD AND EXAMINER'S OBJECTION

	TAXPAYER:	EXAMINER:	LINE:
new UNICAP method average absorption ratio:	6.774%	6.774%	(1)
old UNICAP method absorption ratio:	8.5%	8.5%	(2)
difference between old & new absorption ratios:	(1.726%)	(1.726%)	(3)
old UNICAP method valuation:	**$63,473**		(4)
pre-UNCAP method valuation:		**$58,500**	(5)
times: difference in old & new absorption ratios:	(1.726%)	(1.726%)	(6)
equals: § 481(a) adjustment	**($ 1,096)**	**($ 1,010)**	(7)
new UNICAP method valuation:	$62,463	$62,463	(8)
less: old UNICAP method valuation:	$63,473	$63,473	(9)
equals: § 481(a) adjustment	**($ 1,010)**	**($ 1,010)**	(10)

The examiner argues that the taxpayer's method of calculating its § 481(a) adjustment must necessarily be wrong because it results in a § 481(a) adjustment ($1,096 in line 7) which is not the same as the difference ($1,010 in line 10) between the values of the increment under the new UNICAP method ($62,463) and under the old UNICAP method ($63,473).

The examiner further argues that the taxpayer's § 481(a) calculation reaches this incorrect result because it applies the difference in UNICAP absorption ratios against the old UNICAP method increment valuation, which contains both § 471 costs[3] *and* additional 263A costs[4] as determined under the old UNICAP method, rather than the

[3] See § 1.263A-1(d)(2).

[4] See § 1.263A-1(d)(3).

pre-UNICAP method increment valuation, which contains only § 471 costs. Accordingly, the taxpayer's § 481(a) calculation incorrectly computes and includes an amount of additional § 263A costs with respect to the additional § 263A costs already accrued under the old UNICAP method. This in turn incorrectly increases the magnitude of the negative § 481(a) adjustment to the taxpayer's favor.

LAW:

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Section 446(e) provides that, except as expressly provided elsewhere, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

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

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

Section 1.263A-7T(e)(1)(i) provides that, under § 263A and the regulations thereunder, taxpayers are required to change their method of accounting with respect to inventory property, effective for taxable years beginning after December 31, 1986. The required change in method of accounting is to be made by revaluing the items or costs included in beginning inventory in the year of change as if the new capitalization rules of § 263A and the regulations thereunder had been in effect during all prior periods. The difference between the inventory as originally valued and the inventory as revalued by applying the new capitalization rules is equal to the amount of the adjustment required under § 481(a).

Section 1.263A-7T(e)(6)(iv)(A) provides that taxpayers 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 described in § 1.263A-7T(e)(6)(iv). The 3-year average method is based upon the weighted 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).

ANALYSIS:

The four issues discussed below are interrelated, and the conclusion reached with respect to a given issue may affect calculations relating to the other issues. For simplicity, each issue will be discussed independently of the others and without consideration of any modifications of the calculations that would be required because of conclusions reached with respect to the other issues.

1. Use of pre-UNICAP method

The first issue is whether the 3-year revaluation factor for the taxpayer’s change in method of accounting from the old UNICAP method to the new UNICAP method should be computed by comparing the taxpayer’s pre-UNICAP method to its new UNICAP method (as the taxpayer asserts), or by comparing the taxpayer’s old UNICAP method to its new UNICAP method (as the examiner asserts).

The taxpayer raises two lines of argument. First, the taxpayer asserts that § 1.263A-7T expressly authorizes it to compute its 3-year revaluation factor with reference to its pre-UNICAP method. The taxpayer points specifically to the example in § 1.263A-7T(e)(6)(iv)(C), in which the 3-year revaluation factor is computed with reference to a pre-UNICAP method to determine the § 481(a) adjustment for an initial adoption of a UNICAP method. The taxpayer’s argument implicitly assumes that the example in § 1.263A-7T(e)(6)(iv)(C) provides a substantive rule and is not simply an example based upon its particular facts.

Second, the taxpayer argues that §1.263A-7T should allow a taxpayer changing from one UNICAP method to another to utilize two alternative methods for computing its 3-year revaluation factor: either by comparing its pre-UNICAP method to its new UNICAP method, or by comparing its old UNICAP method to its new UNICAP method. The asserted justification for allowing such a taxpayer two options for computing its § 481(a) adjustment is that these options place the taxpayer in a no less favorable position than it would have been in if it had not adopted a UNICAP method for its first taxable year after December 31, 1986. Stated another way, this option is assertedly necessary to prevent the prompt adopters of UNICAP from being penalized.

The examiner disagrees, and raises three arguments. First, the examiner argues that the revaluation is erroneous because the two methods of accounting upon which the taxpayer bases its revaluation (the pre-UNICAP method and the new UNICAP method) are different from the two methods of accounting that are actually involved in the change (the old UNICAP method and the new UNICAP method). A proper revaluation of the taxpayer's inventory should be based upon the two methods of accounting actually involved in the change: the old UNICAP method (prior method) and the new UNICAP method (new method).

The examiner's second argument is that the taxpayer is improperly revaluing its inventory as if it had never adopted a UNICAP method at all, even though it has in fact used a UNICAP method for its inventories since 1988. The examiner notes that the taxpayer computes its new UNICAP method average absorption ratio without any reference to its old UNICAP method. Further, the taxpayer applies the new UNICAP method average absorption ratio to each increment of its inventory, without regard to whether the old UNICAP absorption ratio of the increment was 10.0% or 7.5%.

Third, the examiner argues that the revaluation and the attendant § 481(a) adjustment determined by the taxpayer reflect two different components, only one of which is attributable to the change in method of accounting. Part of the adjustment is attributable to the changes in the types of costs that are capitalized and the manner in which they are capitalized under the taxpayer's old UNICAP method and its new UNICAP method. The examiner agrees that this amount is properly included in the § 481(a) adjustment. The remainder of the adjustment, however, is attributable to the taxpayer's declining UNICAP absorption ratio, which reflects its improved operating efficiency. This amount reflects a change in facts, and, according to the examiner, should not be included in a § 481(a) adjustment.

As will be discussed in more detail below, we conclude that the taxpayer's change is not governed by § 1.263A-7T or other specific guidance; rather, the change is subject only to the general principles of §§ 446 and 481. Under these principles, the 3-year average method in §§ 1.263A-7T and 1.263A-7 is a reasonable method for the taxpayer to calculate the § 481(a) adjustment attributable to the change. However, the 3-year revaluation factor must be calculated with reference to the accounting methods involved in the change, namely the old UNICAP method and the new UNICAP method.

<u>§ 1.263A-7T</u>

Section 1.263A-7T applies only to accounting method changes where the taxpayer changes to a method of accounting under § 263A for the first time. The limited scope of § 1.263A-7T is evident both in its history and in its language.

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

Section 1.263A-1T, containing the initial temporary regulations under § 263A, was issued in 1987. T.D. 8131, 1987-1 C.B. 98. Consistent with the legislative history, § 1.263A-1T(e) required taxpayers to change their methods of accounting for inventories to comply with § 263A, effective for taxable years beginning after December 31, 1986. The required change was to be made by revaluing the items or costs included in beginning inventory in the year of change as if the new capitalization rules of § 263A and § 1.263A-1T had been in effect during all prior periods. Section 1.263A-1T(e) incorporated and expanded upon the simplified inventory revaluation methods suggested by the legislative history, including the weighted average method (§ 1.263A-1T(e)(6)(iii), subsequently renumbered as § 1.263A-7T(e)(6)(iii)) and the 3-year average method (§ 1.263A-1T(e)(6)(iv), subsequently renumbered as § 1.263A-7T(e)(6)(iv)). The text of § 1.263A-1T(e) clearly indicates throughout that the inventory revaluation provisions, including the 3-year average method, apply to the revaluations required by the enactment of § 263A.

In 1994, the accounting method change provisions of § 1.263A-1T(e) were redesignated as § 1.263A-7T(e). T.D. 8559, 1994-2 C.B. 32. As part of this redesignation, numerous clarifying changes in wording were made to remove references to § 1.263A-1T that were present in § 1.263A-1T(e), but no substantive changes were made.[5]

In 1997, § 1.263A-7T was replaced with § 1.263A-7, the final regulations for UNICAP accounting method changes. T.D. 8728, 1997-2 C.B. 24. Unlike § 1.263A-7T, these final regulations in § 1.263A-7 are not limited to accounting method changes where the taxpayer changes to a method of accounting under § 263A for the first time; they also apply to changes from one UNICAP method to another. § 1.263A-7(a). The inventory revaluation provisions of §1.263A-7 are substantially similar to those in § 1.263A-7T. Several of the revaluation methods from § 1.263A-7T(e) are incorporated into the final regulations, including the 3-year average method. § 1.263A-7(c)(2)(v).

In addition to the history of § 1.263A-7T, the language of the regulation clearly indicates that it applies only to accounting method changes where the taxpayer

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[5] For example, in the first sentence of § 1.263A-1T(e)(1), the phrase “under this section,” which referred to § 1.263A-1T, was replaced with “under section 263A and the regulations thereunder” in § 1.263A-7T.

changes to a method of accounting under § 263A for the first time. Specifically, § 1.263A-7T(e)(1)(i) introduces the regulation by noting that taxpayers are required to change their methods of accounting with respect to inventory property to comply with § 263A and the regulations thereunder, effective for taxable years beginning after December 31, 1986. The required change in method of accounting "is to be made by revaluing the items or costs included in beginning inventory in the year of change as if the new capitalization rules of section 263A and the regulations thereunder had been in effect during all prior periods." [6] The § 481(a) adjustment for the change equals "the difference between the inventory as originally valued and the inventory as revalued by applying the new capitalization rules." [7]

Finally, other Service and Treasury guidance have recognized that § 1.263A-7T applies only to accounting method changes where the taxpayer changes to a method of accounting under § 263A for the first time. See Rev. Proc. 94-49, §§ 3.02(3) ("See § 1.263A-7T(e) for the procedures that a taxpayer must use to revalue items or costs included in its inventory for the first taxable year it is subject to § 263A."), 4.07 ("Section 1.263A-7T(e) provides procedures that a taxpayer must use to revalue the items or costs included in its inventory for the first taxable year it is subject to § 263A."); T.D. 8728, 1997-2 C.B. at 24-25 ("The temporary regulations contain rules for taxpayers changing their method of accounting to comply with the capitalization rules of section 263A."); Rev. Proc. 95-33, 1995-2 C.B. 380, § 5.06 ("Section 1.263A-7T(e) provides procedures that a taxpayer must use to revalue the items or costs included in its inventory for the first taxable year it is subject to § 263A.").

The conclusion that § 1.263A-7T is not applicable to changes from one UNICAP method of accounting to another UNICAP method of accounting rebuts the taxpayer's argument that its methodology is expressly authorized by the example in § 1.263A-7T(e)(6)(iv)(C). We note, however, that even if § 1.263A-7T were applicable to changes between UNICAP accounting methods, we would disagree that the example

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[6] Contrast §1.263A-7(c)(2)(i), which accommodates the wider range of accounting methods subject to § 1.263A-7, including changes from one UNICAP method to another: "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."

[7] Contrast § 1.263A-7(c)(2)(i), which is drafted to accommodate the wider range of accounting methods subject to § 1.263A-7, including changes from one UNICAP method to another: "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)."

provides a substantive rule defining the 3-year average method. Rather, the 3-year average method is defined by the general language in § 1.263A-7T(e)(6)(iv)(A). The example in § 1.263A-7T(e)(6)(iv)(C) merely demonstrates the application of that method to a particular set of facts, namely an initial adoption of the UNICAP method.

Revenue Procedure 94-49

Revenue Procedure 94-49 offered certain taxpayers a one year window within which to obtain automatic consent to change to a proper UNICAP accounting method, without regard to whether their existing methods of accounting for § 263A costs were proper. More specifically, Rev. Proc. 94-49 generally applied to any taxpayer that changed its method of accounting for § 263A costs to a method permitted or required under the final § 263A regulations for its first taxable year beginning on or after January 1, 1994. Revenue Procedure 94-49 did not apply, however, if the taxpayer was changing its method of accounting to comply with § 263A for the first time; such changes remained subject to § 1.263A-7T(e). Rev. Proc. 94-49, §§ 3.01, 3.02(3).

Accounting method changes qualifying under Rev. Proc. 94-49 were subject to selected provisions of § 1.263A-7T, including § 1.263A-7T(e)(6) and the 3-year average method therein. Accordingly, a change in method of accounting from one UNICAP method to another UNICAP method that qualified under Rev. Proc. 94-49 was subject to the selected provisions of § 1.263A-7T(e), even though § 1.263A-7T would not otherwise apply to such a change. Rev. Proc. 94-49, § 4.07(2).

The fact that Revenue Procedure 94-49 makes certain provisions of § 1.263A-7T temporarily applicable to changes from one UNICAP method to another UNICAP method is in itself additional evidence that § 1.263A-7T is not otherwise applicable to such changes. If § 1.263A-7T were otherwise applicable to such changes, then the provisions of Rev. Proc. 94-49 making them applicable to such changes would not have been necessary.

Sections 446 and 481

As established above, the taxpayer had no express regulatory or administrative authorization to use the 3-year average method to revalue its inventory for purposes of computing its § 481(a) adjustment. Section 1.263A-7T(e)(6) does not apply to the taxpayer's change in method of accounting because it does not apply to changes from one UNICAP method to another UNICAP method. Revenue Procedure 94-49, which makes § 1.263A-7T(e)(6) applicable to changes in methods of accounting made pursuant to it, does not apply to the taxpayer's change in method of accounting at issue here because the year of change is not the taxpayer's first taxable year beginning on or after January 1, 1994. Finally, § 1.263A-7(c)(6) does not apply to the change in method of accounting at issue here because it is not effective for the taxpayer's year of change.

As a result, the taxpayer's change in method of accounting is governed only by the general principles established in §§ 446 and 481. Under such principles, the taxpayer was required to obtain the consent of the Commissioner to make the change in method of accounting. § 446(e). The taxpayer was also required by § 481(a) to take into account those adjustments which were determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted. Specifically, the required adjustment under § 481(a) equals the difference between the taxpayer's closing inventory in the preceding year, as computed under its old method of accounting, and the taxpayer's opening inventory, as computed under its new method of accounting. § 1.263A-7(c)(2)(i).

We believe that the 3-year average method, as described generally in the § 263A legislative history, § 1.263A-7T(e)(6) and § 1.263A-7(c)(6), is generally a reasonable method for a taxpayer to revalue its dollar-value LIFO inventories when changing from one UNICAP method of accounting to another UNICAP method of accounting. We further believe, however, that this method is not reasonable where the revaluation factor is calculated with reference to any methods of accounting other than the two methods involved in the change, namely the old method and the new method. Such a calculation is contrary to the general principles of §§ 446 and 481 in at least two basic respects.

First, revaluing inventories computed under the old UNICAP method as if they were computed under the new UNICAP method on the basis of a revaluation ratio computed between the pre-UNICAP method and new UNICAP method is intuitively incorrect. The ratio between 3 years of inventory values computed under the pre-UNICAP method to the same 3 years of inventory values computed under the new UNICAP method is logically irrelevant to the revaluation of inventories computed under the old UNICAP method as if they were computed under the new UNICAP method.

This intuition can also be expressed mathematically. The 3-year average method revalues inventories from the old UNICAP method ("B") to the new UNICAP method ("C"). This is accomplished by multiplying B by the 3-year revaluation factor to yield C. In mathematical terms, therefor, the 3-year revaluation factor must be the number that yields C when it is multiplied against B. Algebra establishes that this number is the ratio of C to B:

$$B \times (C / B) = C$$

It is not the ratio of C to some other number A. The use of C/A as the revaluation factor results in (B x C) / A, which equals C only in the unusual case where B equals A:

$$B \times (C / A) = (B \times C) / A$$

The equations illustrate that the revaluation of inventories from method B to method C is only accomplished by comparing the two methods involved in the change; any other method A is simply irrelevant.

Second, revaluing inventories using a revaluation ratio computed with reference to accounting methods other than the old and new methods violates the requirement of § 481(a) that the adjustment "be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted." For the taxpayer's change, such adjustment is the amount that reflects the changes in the types of cost capitalized and the manner of capitalization which are caused by the change from the taxpayer's old UNICAP method to its new UNICAP method. The § 481(a) adjustment calculated by the taxpayer, however, effectively includes both (i) the change in additional § 263A costs attributable to its present change in method from its old UNICAP method to its new UNICAP method, and (ii) the change in additional § 263A costs attributable to the earlier change from its pre-UNICAP method to its old UNICAP method. Accordingly, the taxpayer's § 481(a) adjustment is incorrect because it includes amounts that are not necessary solely because of its change in accounting method.

For all of the foregoing reasons, we conclude that the taxpayer could reasonably use the 3-year average method to compute the § 481(a) adjustment for its change in method of accounting, even in the absence of an applicable regulation that expressly authorizes the use of such method. We further conclude, however, that it was not reasonable for the taxpayer to calculate its revaluation factor under this method with reference to accounting methods other than the old UNICAP method and the new UNICAP method, which were the methods involved in the change.

2. Substitution of new UNICAP method average absorption ratio for old UNICAP method absorption ratios

The examiner's second objection is that the taxpayer improperly recomputes the additional § 263A costs under the new UNICAP method by substituting the same absorption ratio – the new UNICAP method average absorption ratio – for every increment, without any regard to the existing absorption ratios of the various increments under the old UNICAP method. The examiner urges that the 3-year revaluation factor should be used to adjust the old UNICAP method absorption ratios for each increment individually.

The methodology used by the taxpayer – computing a new UNICAP absorption ratio and using that same ratio to compute additional § 263A costs for every increment in the inventory – is appropriate to estimate additional § 263A costs under the new method of accounting in cases where a taxpayer is changing to a method of accounting under § 263A for the first time. In such instances, a taxpayer has no additional § 263A costs attributable to its inventory, and is computing such costs for the first time. Accordingly, a single UNICAP absorption ratio must be estimated using the 3-year sample period, and that ratio is properly applied against all increments to estimate additional § 263A costs attributable to the inventory.

However, the taxpayer's methodology does not provide an acceptably accurate estimation of additional 263A costs under the new method of accounting in cases where a taxpayer changes from one UNICAP method to another UNICAP method. In such cases, only the examiner's methodology -- computing a 3-year revaluation factor to adjust the existing UNICAP absorption ratios -- provides an acceptably accurate estimate. This conclusion is supported by three basic criteria that an acceptably accurate estimate should satisfy.

First, an accurate revaluation should preserve and reflect the basic facts regarding a taxpayer's history of additional 263A costs. In the case of the taxpayer, for example, the old UNICAP method absorption ratio in its base year increment (10%) is significantly higher than the old UNICAP method absorption ratio in its 1995 increment (7.5%). Simply stated, the taxpayer incurred proportionately greater additional § 263A costs in its base year than in 1995. The examiner's methodology creates UNICAP absorption ratios for the base year increment (8.84%) and 1995 year increment (6.630%) that properly reflect this basic relationship. The taxpayer's method, which substitutes the same new UNICAP method average absorption ratio (6.774%) for both the base year and 1995 increments, effectively ignores the known difference in the § 263A absorption ratios between the base year increment and the 1995 year increment.

Second, an accurate revaluation should limit the § 481(a) adjustment to amounts that are necessary solely because of the change in method of accounting. The examiner's methodology does this. Under the taxpayer's methodology, however, the § 481(a) adjustment includes amounts that are not attributable to any change in method of accounting made by the taxpayer.

For example, during the three years that the taxpayer chose for purposes of calculating the revaluation factor, the UNICAP absorption ratio of the taxpayer declined approximately an average of 16.7 percent, as shown in Table 6, below.

TABLE 6: CHANGE IN UNICAP ABSORPTION RATIOS FROM OLD UNICAP METHOD TO NEW UNICAP METHOD

	(A) Old UNICAP Method -- Absorption Ratio	(B) New UNICAP Method – Actual Absorption Ratio	(C = A - B) Point Change	(D = C/A) % Change
1993	8.5%	7.5%	(1.0)	(11.8%)
1994	8.0%	6.5%	(1.5)	(18.8%)
1995	7.5%	6.0%	(1.5)	(20.0%)
	24.0%	20.0%	(4.0)	(16.7%)

Under the taxpayer's calculation, however, the same new UNICAP method average absorption ratio (6.774%) is applied to all increments of the inventory, without regard to what the UNICAP absorption ratios of the various increments were under the old UNICAP method. For many increments, this results in a percentage decrease in the UNICAP absorption ratio far in excess of 16.7 per cent. See column D in Table 3, repeated below.

TABLE 3: TAXPAYER REVALUATION – UNICAP ABSORPTION RATIOS

	(A) Old UNICAP method – absorption ratio	(B) New UNICAP method – actual absorption ratio	(C) New UNICAP method – average absorption ratio (taxpayer's 3-year average method calculation)	(D) % Change from A to C (= [C-A] / A)
BASE	10.0%		6.774%	-32%
1991	9.5%		6.774%	-29%
1992	9.0%		6.774%	-25%
1993	8.5%	7.5%	6.774%	-20%
1994	8.0%	6.5%	6.774%	-15%
1995	7.5%	6.0%	6.774%	-10%

This difference can be seen clearly in the base year increment. Under the taxpayer's old UNICAP method, the UNICAP absorption ratio is 10.0%. The taxpayer revalues the base year increment by substituting the new UNICAP method average absorption ratio of 6.774%. This revaluation results in a 32% decrease in the UNICAP absorption ratio, which is nearly twice the 16.7% average decrease in UNICAP absorption ratios from the old UNICAP method to the new UNICAP method during the 3 years used for applying the 3-year average method.[8]

Of the 32% decrease in the UNICAP absorption ratio for the base year increment, only 16.7 percentage points -- reflecting the 3-year average decrease in UNICAP absorption ratios caused by the change in accounting method -- are attributable to the taxpayer's change in method of accounting. The remaining 15.3 percentage points of decrease are not attributable to the change; rather, they reflect a change in the circumstances of the taxpayer (an increasing operating efficiency and a decreasing UNICAP absorption ratio) that are not related to the accounting method change.

The § 481(a) adjustment for the base year increment should include only amounts related to the 16.7 per cent decrease attributable to the change. The taxpayer's § 481(a) adjustment for the base year increment is erroneous because it also includes an amount related to the 15.3 per cent decrease that is not caused by the accounting method change.

Third, an accurate revaluation should incorporate all sources of relevant information to estimate the additional § 263A costs under the new method of accounting. The taxpayer's methodology utilizes only one source of information: the average change in additional § 263A costs attributable to inventory under the old and new UNICAP methods during the 3-year sample period. The examiner's methodology utilizes two sources of information: first, the average change in additional § 263A costs attributable to inventory under the old and new UNICAP methods during the 3-year sample period; and second, the additional § 263A costs attributable to the increments under the old method of accounting.

In the case of a taxpayer changing to a UNICAP method for the first time, the additional § 263A costs under the old method are zero, and only one source of information is available. Under such circumstances, the taxpayer's methodology utilizes the only information available to estimate additional § 263A costs under the new method, and is an appropriate means of estimation.[9] In the case of a taxpayer

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[8] The actual data for the taxpayer's base year increment presents a more pronounced example. The taxpayer's old UNICAP method absorption ratio is A%, and the new UNICAP method average absorption ratio is B%. Thus, the revaluation results in a C% decrease in the UNICAP absorption ratio for the base year increment, which is more than X times the D% average decrease in UNICAP absorption ratios from the old UNICAP method to the new UNICAP method during the 3 sample years used for applying the 3-year average method.

[9] In fact, the examiner's methodology cannot be utilized for initial changes to a UNICAP method, as there are no UNICAP absorption ratios to adjust.

changing from one UNICAP method of accounting to another UNICAP method of accounting, however, two sources of information are available. The taxpayer's methodology ignores one of these sources of information, while the examiner's methodology utilizes both available sources, thereby providing a superior estimation of additional § 263A costs under the new method.

We conclude, therefor, that the taxpayer's methodology is appropriate to estimate additional § 263A costs in cases involving a change to a UNICAP method of accounting for the first time. However, the taxpayer's methodology does not provide an acceptably accurate estimate of additional § 263A costs in cases, such as the present one, involving a change from one UNICAP method of accounting to another UNICAP method of accounting. In such circumstances, only the examiner's methodology estimates additional § 263A costs with sufficient accuracy to satisfy the requirements of §§ 446 and 481. Accordingly, we agree with the examiner that the taxpayer's inventories should be revalued using the methodology urged by the examiner.

3. Current cost of increments versus total current costs

The examiner's third objection to the § 481(a) calculation is that the taxpayer calculates its revaluation factor on the basis of the average change in the <u>current cost of inventory increments</u> of the three taxable years preceding the year of change, rather than the average change in the <u>total current costs</u> of inventory for those years.

The descriptions of the 3-year average method in the § 263A legislative history, § 1.263A-7T(e)(6), and § 1.263A-7(c)(6) all specify the use of total current costs of inventory in the calculation of the revaluation factor. In addition, total current costs are clearly used to calculate revaluation factors in the computational examples. For example, in the calculation of the revaluation factor in § 1.263A-7(c)(2)(v)(C)(ii), the amount for the year 1996 is $54,400, which represents the total current costs in inventory for the year 1996, rather than $5,000, which is the 1996 LIFO increment as shown in § 1.263A-7(c)(2)(v)(C)(i).

Total current costs are intrinsically superior to inventory increments as a basis for computing a weighted average change in inventory values. Inventory increments represent only a portion of the taxpayer's total inventory value. As such, inventory increments are subject to wide variations, particularly on a percentage basis, from year to year, which could distort the revaluation factor. Total current costs represent the entire inventory value for a year, and thus are a more stable and suitable basis for determining a weighted average change in inventory values.

Accordingly, we agree with the examiner that the taxpayer should have used total current costs, rather than increments, in its calculation of the revaluation factor.[10]

4. § 481(a) calculation for increments

The examiner's fourth objection is that the taxpayer's calculation uses an erroneous procedure to determine the § 481(a) adjustment attributable to the various increments. As discussed above, the taxpayer computes the percentage point difference between the UNICAP absorption ratio under its old UNICAP method and the new UNICAP method average absorption ratio it computes in its version of the 3-year average method. This difference is then multiplied by the increment as valued under the old UNICAP method to determine the § 481(a) adjustment attributable to the increment.

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[10] For illustration purposes, the corrected calculation of the revaluation factor would be as follows:

	Pre-UNICAP total current costs at current value	Index	Pre-UNICAP total current costs at current value
1993	$ 645,000	1.3	$ 838,500
1994	$ 650,000	1.4	$ 910,000
1995	$ 685,000	1.5	$ 1,027,500
TOTALS			$ 2,776,000

For example, the 1993 figure of $645,000 equals $500,000 (base year) + $45,000 (1991) +55,000 (1992) + 45,000 (1993).

	(A)	(B)	(C = A x B)	(D)	(E = A x D)
	Pre-UNICAP total costs at base	Old UNICAP method -- absorption ratio	Old UNICAP method – additional § 263A costs	New UNICAP method – absorption ratio (actual)	New UNICAP method – additional § 263A costs
1993	$ 838,500	8.5%	$ 909,773	7.5%	$ 901,388
1994	$ 910,000	8.0%	$ 982,800	6.5%	$ 969,150
1995	$ 1,027,500	7.5%	$ 1,104,563	6.0%	$ 1,089,150
TOTALS			$ 2,997,136		$ 2,959,688

Revaluation factor = $2,959,688 / $2,997,136 = 0.9875

The examiner points out that the taxpayer's calculation reflects a revaluation from the pre-UNICAP method to the new UNICAP method, rather than the old UNICAP method to the new UNICAP method. Thus, the difference between the UNICAP absorption ratios – which represents the revaluation factor in taxpayer's calculations – should be multiplied against the increment as valued under the pre-UNICAP method, rather than the old UNICAP method, to determine the § 481(a) amount attributable to the increment.

The examiner's argument may appear more clearly in a simplified example. Assume that the taxpayer had determined that its new UNICAP method average absorption ratio was 5%, and that the taxpayer is revaluing a hypothetical increment that has a value of $100 under its pre-UNICAP method and a value of $110 under its old UNICAP method (equivalent to a 10% UNICAP absorption ratio).

	Increment Value	UNICAP Absorption Ratio
Pre-UNICAP method:	$100	0%
Old UNICAP method:	$110	10%
New UNICAP method:	$105	5%
§ 481(a) adjustment:	$ -5	-5%

The taxpayer's § 481(a) calculation fails to reach the same result as the change in inventory valuations between the old UNICAP method and the new UNICAP method, which is sufficient in itself to indicate that the taxpayer's § 481(a) calculation is flawed. The correct § 481(a) adjustment for this increment would be -$5, which equals the value of the increment under the new UNICAP method ($105) minus the value of the increment under the old UNICAP method ($110). The examiner's approach applies the difference in absorption ratios (-5%) against the pre-UNICAP value of the increment ($100), which correctly yields -$5. The taxpayer's § 481(a) calculation applies the difference in absorption ratios (-5%) against the increment as valued under the old UNICAP method ($110), which incorrectly yields -$5.50.

Further, it is evident that the taxpayer's § 481(a) calculation reaches an incorrect result because it applies the difference in UNICAP absorption ratios against the old UNICAP method increment valuation ($110), which contains both § 471 costs ($100) *and* additional § 263A costs as determined under the old UNICAP method ($10), rather than the pre-UNICAP method increment valuation, which contains only § 471 costs ($100). Accordingly, the taxpayer's § 481(a) calculation incorrectly computes and includes an amount of additional § 263A costs that is attributable to the additional § 263A costs already accrued under the old UNICAP method. This incorrectly increases the magnitude of the negative § 481(a) adjustment by -$0.50 (the difference in UNICAP absorption ratios (-5%) multiplied by the additional 263A costs under the old UNICAP method ($10) that are included in the old UNICAP method increment valuation ($110)).

Accordingly, we agree with the examiner that the taxpayer's calculation of its § 481(a) adjustment was incorrect.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.