Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 471, 472; 1.471-2, 1.471-8, 1.472-1)

Rev. Proc. 2008-43

SECTION 1. PURPOSE

The Internal Revenue Service traditionally viewed rolling-average inventory valuation as a method of accounting that does not clearly reflect income, especially when inventory is held for several years or costs fluctuate substantially. See Rev. Rul. 71-234, 1971-1 C.B. 148 and Rev. Rul. 77-480, 1977-2 C.B. 186.

However, many industries consider the rolling-average method an accurate estimate of costs and use a rolling-average method for financial statement purposes. The Service recognizes that using a rolling-average for financial statement purposes can produce an accurate approximation of costs. Therefore, this revenue procedure announces that the Service generally will view a rolling-average method that is used to value inventories for financial accounting purposes as clearly reflecting income for federal income tax purposes. However, if inventory is held for several years or costs fluctuate substantially, a rolling-average cost method may or may not clearly reflect income, depending on the particular facts and circumstances. This revenue procedure provides two safe harbors under which a taxpayer's financial accounting rolling-average method will be deemed to clearly reflect income for federal income tax purposes. If a taxpayer does not use a rolling-average method for financial accounting purposes then the rolling-average method may not accurately determine costs or clearly reflect income for federal income tax purposes.

This revenue procedure also provides the procedures by which a taxpayer may obtain automatic consent to change to a rolling-average method. A taxpayer that complies with all the applicable provisions of this revenue procedure has obtained the consent of the Commissioner to change its method of accounting under § 446(e) of the Internal Revenue Code and the regulations thereunder.

SECTION 2. BACKGROUND

.01 Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes income in keeping its books.

.02 Sections 446(e) and 1.446-1(e)(2) of the Income Tax Regulations state that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions necessary to permit a taxpayer to obtain consent to change a method of accounting.

.03 Rev. Proc. 2002-9, 2002-1 C.B. 327 (as 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 procedures for a taxpayer to obtain automatic consent of the Commissioner to change to a method of accounting described in the Appendix of Rev. Proc. 2002-9.

.04 Section 471 provides that inventories must be taken on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

.05 Section 1.471-2(c) permits merchants and manufacturers to value inventories at either (1) cost, or (2) cost or market, whichever is lower (LCM). When applying one of these valuation methods, a taxpayer uses a cost-flow assumption, such as first-in, first-out (FIFO) or last-in, first-out (LIFO), to identify the items in ending inventories.

.06 Section 472(a) provides that a taxpayer may use the LIFO inventory method. Under § 472(b)(2), a taxpayer using the LIFO inventory method must value its goods at cost.

.07 Section 1.471-3(b) defines the cost of merchandise purchased since the beginning of the taxable year as the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which a taxpayer may or may not deduct at the taxpayer's option, provided the taxpayer does so consistently. Transportation and other necessary charges incurred in acquiring possession of the goods are added to this net invoice price.

.08 In the case of merchandise produced by the taxpayer, § 1.471-3(c) defines cost as (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including an appropriate portion of management expenses, but not including any cost of selling or return on capital. *See* §§ 1.263A-1 and 1.263A-2 for more specific rules regarding the treatment of production costs.

.09 Section 1.471-3(d) provides that in any industry in which the usual rules for computation of cost of production are inapplicable, cost may be approximated upon a basis that is reasonable and in conformity with established trade practice in that industry.

SECTION 3. SCOPE

This revenue procedure applies to a taxpayer that is required to account for inventories under § 471 and uses a rolling-average method to value those inventories for financial accounting purposes.

SECTION 4. ROLLING-AVERAGE METHOD SAFE HARBORS

.01 <u>In general</u>. A taxpayer's use of the rolling-average method it uses for financial accounting purposes to value inventories for federal income tax purposes will be deemed to clearly reflect income if--

(1) The taxpayer recomputes the rolling average cost of an inventory item on one of the following bases:

(A) Each time the taxpayer purchases or produces an additional unit or units of that item; or

(B) On a regular basis but no less frequently than once per month; and

(2) The taxpayer satisfies one of the following conditions:

(A) The variance percentage, as determined under section 4.02 of this revenue procedure, does not exceed one percent; or

(B) The entire inventory of a taxpayer's trade or business turns at least four times per year, as determined under section 4.03 of this revenue procedure.

.02 Determination of variance percentage. The variance percentage is determined by--

(1) Subtracting the cost of the ending inventory of the trade or business computed using the taxpayer's rolling-average method from the cost of the ending inventory of the trade or business computed using either the FIFO method or the specific identification method to determine the variance; and then

(2) Dividing the variance by the aggregate rolling-average cost of the inventory.

.03 Determination of inventory turns. The number of times that the entire inventory of a taxpayer's trade or business turns during a taxable year is equal to the cost of goods sold divided by average inventory (average of beginning and ending inventory). A taxpayer that uses a LIFO cost-flow assumption for tax purposes must calculate inventory turns using rolling-average cost and a FIFO cost-flow assumption.

SECTION 5. PROCEDURES FOR CHANGING METHOD OF ACCOUNTING

.01 Taxpayers are granted the consent of the Commissioner to change to a rolling-average method of accounting permitted under section 4 of this revenue procedure in accordance with the applicable provisions of Rev. Proc. 2002-9 or any successor, subject to the following modifications:

(1) The scope limitation in section 4.02(6) of Rev. Proc. 2002-9 does not apply to the change to a rolling-average method in the taxpayer's first or second taxable year ending on or after December 31, 2007; and

(2) The designated automatic accounting method change number for changes in

method of accounting made pursuant to this revenue procedure is No. 114.

.02 A taxpayer changing to a rolling-average method of accounting must use a cut-off method unless the taxpayer's books and records contain sufficient information to compute a § 481(a) adjustment, in which case the taxpayer may choose to implement the change with a § 481(a) adjustment as provided in sections 5.03 and 5.04 of Rev. Proc. 2002-9.

SECTION 7. AUDIT PROTECTION

A taxpayer's use of a rolling-average method of accounting in accordance with section 4 of this revenue procedure on a federal income tax return filed before June 25, 2008, will not be raised as an issue by the Service. Moreover, if a taxpayer's use of a rolling-average method in accordance with section 4 of this revenue procedure on a federal income tax return filed before June 25, 2008, is an issue under consideration in examination, appeals, or before the Tax Court, the Service will not further pursue the issue.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Rul. 71-234, 1971-1 C.B. 148, and Rev. Rul. 77-480, 1977-2 C.B. 186, are modified to permit taxpayers to use a rolling-average method of accounting for inventories as provided under this revenue procedure. Rev. Proc. 2002-9 is modified and amplified to include in the APPENDIX the automatic change provided in this revenue procedure.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2007.

DRAFTING INFORMATION

The principal author of this revenue procedure is Leo F. Nolan II of the office of the Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Nolan at (202) 622-4970 (not a toll-free call).