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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated November 20, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
$X =
$Y =

ISSUES

1. Whether Taxpayer's method of accounting is a permissible method when it includes in inventoriable costs an estimated amount of a liability that does not meet the requirements of Treas. Reg. §§ 1.446-1(c)(1)(ii)(A) and (B).

2. Whether the all-events test and the economic performance requirement set forth in Treas. Reg. § 1.446-1(c)(1)(ii)(A) and (B) are valid regulations in their application to inventoriable costs.

CONCLUSIONS

1. Taxpayer's method of accounting is not a permissible method.

2. The all-events test and the economic performance requirement set forth in Treas. Reg. §§ 1.446-1(c)(1)(ii)(B) are valid regulations in their application to inventoriable costs.

FACTS

Application for Change in Accounting Method - Background

Taxpayer uses an accrual method of accounting. Late in Year 4, Taxpayer filed a Form 3115, Application for Change in Accounting Method, with the examining agents under the automatic consent provisions of Section 4.12 of Rev. Proc. 94-49, 1994-2 C.B. 705, effective for taxable years beginning on or after January 1, Year 4. A copy of the Form 3115 was filed with the national office in Year 5. The national office filing included a cover letter that provided a more detailed description of the change in accounting method for environmental cleanup costs because the description of the proposed change in the copy provided to the examining agents was "somewhat brief."

In the Form 3115, Taxpayer requested two principal changes. The first dealt with Taxpayer's method of capitalizing additional I.R.C. § 263A costs. Taxpayer proposed changing its method of cost capitalization from the simplified production method of Reg. § 1.263A-2(b) to a facts and circumstances method.

The second change in accounting method involved the identification and accrual of certain inventoriable costs - plant and environmental cleanup site costs, post-retirement benefit medical costs, and supplemental benefit costs. Taxpayer proposed capitalizing, i.e., including in inventoriable costs, these costs when they became "subject to reasonable estimation." Under its prior method, Taxpayer treated environmental cleanup costs as deductions from gross income to arrive at net taxable income and deducted these costs when economic performance occurred. Similarly, Taxpayer deducted employee benefits costs based on the provisions of section 404 and section 419, which generally allow the deductions to be claimed when payment for those liabilities has been made. The taxpayer's section 481(a) adjustment included estimated environmental cleanup costs of $X and estimated employee benefit costs of $Y.

The proposed change in accounting method would cause Taxpayer's environmental cleanup and employee benefit costs to be included in inventoriable costs and recovered through cost of goods sold rather than deducted from gross income. Taxpayer's position was that the all-events test and the economic performance rules apply only to deductions from gross income and do not apply to cost of goods sold, which is offset against total sales to determine gross income.

When the Form 3115 was filed, Taxpayer's Year 1, Year 2, and Year 3 returns were under examination, but Taxpayer's inventory cost capitalization was not a pending issue. The examination of inventoriable costs was suspended, as required by Rev. Proc. 94-49, 1994-2 C.B. 705.

Action Taken on Application for Change in Accounting Method

The Assistant Chief Counsel (ITA) denied Taxpayer's application for change in accounting method. The letter denying the request states in pertinent part:

> The Form 3115 you filed request[s] permission to accrue the above costs [plant and site cleanup costs, post-retirement medical benefits and other costs not presently included in inventoriable costs] when they become subject to reasonable estimation and to include them in inventoriable costs when they accrue. Rev. Proc. 94-49 does not apply to a change that involves the proper time for accruing costs under section 461. Furthermore, you propose to include the above costs in inventoriable costs earlier than the taxable year during which the costs are incurred under section 461, contrary to Reg. § 1.446-1(c)(1)(ii)(A) and Reg. § 1.263A-1(c)(2)(ii).

After receiving the denial letter from the National Office for its requested change in accounting method, Taxpayer did not file an amended return for the Year 4 tax year. As described below, Taxpayer also chose to file the Year 5 tax return using a variation of the method proposed in the Form 3115.

Year 4 and Year 5 Tax Returns

On examination of Taxpayer's Year 4 and Year 5 returns, Form 1120, it was discovered that Taxpayer used a variation of the accounting method that it requested on its Form 3115. Taxpayer treated environmental cleanup costs that satisfied the all-events test, including the economic performance requirement, during the year as current period expenses.[1] In this regard, Taxpayer deducted the entire amount of those environmental cleanup costs instead of including them in inventoriable costs which might have deferred some portion of the costs as part of the ending inventory. Environmental cleanup costs that did not satisfy the all-events test, on the other hand, were treated as inventoriable costs and recovered through cost of goods sold.

Likewise, Taxpayer treated employee benefit payments subject to sections 404 and 419 (hereafter referred to as “accruable employee benefits”) as current period expenses, and deducted them from gross income.[2] The accrued employee benefits that did not comply with the rules of sections 404 and 419 (hereafter referred to as non-accruable employee benefits) were inventoried and recovered through cost of goods sold.

Explanatory Statements, Regulation Disclosure Statement, Form 8725R, attached to the Year 4 and Year 5 returns reference Treas. Reg. §§ 1.446-1(c)(1)(ii)(B) and 1.61-3(a), and disclose that, “[Taxpayer] has concluded that the referenced regulation sections are invalid in their extension of Section 461(h) economic performance principles to items historically and consistently described in case law and statutes, not as deductions, but as exclusions.”

Taxpayer asserts that its treatment of items entering into the computation of cost of goods sold is supported by: (1) legislative history of section 461(h), (2) case law and statutes that separately treat “exclusions” from gross receipts and “expenses” and (3) Service and Department of Treasury pronouncements that distinguish between “exclusions” and “expenses.”

LAW AND ANALYSIS

Issue 1. Whether Taxpayer’s method of accounting is a permissible method when it includes in inventoriable costs an estimated amount of a liability that does not meet the requirements of Treas. Reg. §§ 1.446-1(c)(1)(ii)(A) and (B).

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[1]We assume that the environmental cleanup costs deducted in the taxable year are not also included in Taxpayer’s section 481(a) adjustment as a downward adjustment to income.

[2]Here again, we assume that the employee benefit costs deducted in the taxable year are not also included in Taxpayer’s section 481(a) adjustment as a downward adjustment to income.

Taxpayer is required to maintain inventories pursuant to sections 446 and 471. Furthermore, under section 263A, Taxpayer is required to include in its inventoriable costs the direct costs of its inventory and the indirect costs properly allocable to its inventory. The section 263A regulations, however, provide that a cost may not be included in inventoriable costs until the amount is "incurred," within the meaning of the regulations. Specifically, Reg. § 1.263A-1(c)(2)(ii) provides as follows:

> The amount of any cost required to be capitalized under section 263A may not be included in inventory or charged to capital accounts or basis any earlier than the taxable year during which the amount is incurred within the meaning of § 1.446-1(c)(1)(ii).

For a liability to be "incurred," the regulations require that several criteria must have been met. Reg. § 1.446-1(c)(1)(ii) provides as follows:

> Under such a method [an accrual method of accounting], a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Thus, the income tax regulations clearly provide that the all-events test, including the economic performance rules of section 461(h), apply to inventoriable costs. Consequently, a cost may not be included in inventoriable costs unless and until it has satisfied the all-events test.

Taxpayer argues Rev. Proc. 94-49, 1994-2 C.B. 705, authorized its change to include environmental cleanup and employee benefit costs in inventoriable costs before the all-events test, including the economic performance requirement, was met. Section 4.01 of Rev. Proc. 94-49 automatically grants the consent of the Commissioner to any taxpayer within the scope of the revenue procedure to change its method of accounting to a method required or permitted by the final section 263A regulations. The scope of the revenue procedure is provided in section 3.01. The revenue procedure applies to any taxpayers changing their methods of accounting for costs subject to section 263A for the first taxable year beginning on or after January 1, 1994, to a method required or permitted by §§ 1.263A-1, 1.263A-2, and 1.263A-3 of the final section 263A regulations. Thus, the scope of Rev. Proc. 94-49 as well as the automatic consent provisions of Rev. Proc. 94-49 are limited to changes to methods required or permitted by section 263A and the regulations thereunder.

Taxpayer was not within the scope of Rev. Proc. 94-49 and Taxpayer's proposed accounting method was not within the automatic consent provision of Rev. Proc. 99-49 because Taxpayer proposed to change to a method that was neither required nor permitted by the final section 263A regulations. In fact, Taxpayer's proposed method was expressly prohibited by section 1.263A-1(c)(2)(ii). Thus, the Service properly determined that Taxpayer did not have the Commissioner's consent to change to a method of accounting that includes costs in inventoriable costs that have not satisfied the all-events test.

Not only did Taxpayer change its method without the Commissioner's consent, the method used to compute Taxpayer's income beginning in the Year 4 taxable year is not otherwise permissible. Taxpayer's method is not permissible because it is specifically prohibited by §§ 1.263A-1(c)(2)(ii), and 1.446-1(c)(1)(ii). Moreover, Taxpayer's method of accounting does not clearly reflect income as required by §§ 446 and 471 because a method of accounting that is plainly inconsistent with governing regulations does not clearly reflect income. Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979).

Issue 2. Whether the all-events test and the economic performance requirement set forth in Reg. §§ 1.446-1(c)(1)(ii)(A) and (B) are valid regulations in their application to inventoriable costs.

Taxpayer has recognized that the method of accounting it used to compute taxable income for the taxable year Year 4 and Year 5 is contrary to the income tax regulations. However, Taxpayer maintains that those regulations are invalid because they exceed Congressional intent.

The regulations at issue represent the Service's construction of sections 263A(a), 446(b) and 461(h). The Supreme Court set the following standard for reviewing an agency's construction of a statute in Chevron U.S.A., Inc. v. Natural Resources Defense Council, 467 U.S. 837, 842-843 (1984):

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress had directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of administrative regulation. Rather, if the statute is silent or ambiguous with respect to

> the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.
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> If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are now given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. . . In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator or an agency.[3]

(Footnotes omitted.) The degree of deference given to a regulation depends first on whether the regulation is legislative or interpretive. A regulation that promulgated pursuant to a specific statutory authority "is a substantive rule, legislative in character." Wing v. Commissioner, 81 T.C. 17, 28 (1983). "Where the Commissioner acts under specific authority, [the court's] primary inquiry is whether the interpretation or method is within the delegation authority." Rowan Companies Inc. v. United States. 452 U.S. 247, 253 (1981). Legislative regulations should be given "controlling weight unless they are arbitrary, capricious or manifestly contrary

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[3]The Supreme Court recently refined the Chevron doctrine in United States v. Mead Corp., 121 S.Ct. 2164 (2001). There, the issue was the validity of a tariff classification ruling of the United States Customs Service.

> We hold that administrative implementation of a particular statutory provision qualifies for Chevron deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority. Delegation of such authority may be shown in a variety of ways, as by the agency's power to engage in adjudication or notice-and-comment rulemaking, or by some other indication of a comparable congressional intent.

121 S.Ct 2171 (emphasis added). In concluding that the ruling was not entitled to Chevron deference, the Court focused on the fact that the ruling was not a product of a notice-and-comment rulemaking or formal adjudication. ("Indeed, to claim that classifications have legal force is to ignore the reality that 46 different Customs offices issue 10,000 to 15,000 of them each year..." 121 Sup. Ct. at 2174.) Accordingly, we conclude that nothing in Mead weakens the government's position under Chevron, in that the regulations Taxpayer is challenging were issued under the Service's notice-and-comment rulemaking authority and, thus, under Mead, would be entitled to Chevron deference.

to the statute." Schuler Industries, Inc. v. United States, 109 F.3d 753, 755 (Fed. Cir. 1997) (quoting Chevron, 467 U.S. at 844).[4]

When specific statutory authority for a regulation is not conferred, the Service may promulgate a regulation under the general authority of section 7805(a). These are interpretive regulations, and are not given as much deference as regulations based on a specific statutory authority. General authority regulations are subject to a series of tests pertaining to the underlying legislative intent. Courts look to whether there was "a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent." Rowan Companies, Inc. v. United States, 452 U.S. 247, 253 (1981), quoting National Muffler Dealers Assn. V. United States, 440 U.S. 472, 477 (1979). Other inquiries include whether the Service's interpretation of the regulation has been consistent, whether the regulation is in harmony with other statutes and regulations, and the degree of scrutiny that Congress devoted to the regulation upon subsequent re-enactments. Id. The courts look to prior Treasury pronouncements in order to answer these questions.

The crux of Taxpayer's complaint about Reg. § 1.446-1(c)(1)(ii)(B) is that the regulation defines the term "liability" as including any item allowable as a capitalized cost, or as a cost included in cost of goods sold. Taxpayer argues that because cost of goods sold is an element of the gross income computation under section 1.61-3(a), the accrual of inventoriable costs is effectively governed by section 451 and the regulations thereunder.[5] According to Taxpayer, regulations

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[4]The Federal Circuit invalidated a legislative regulation in Rite Aid Corp. v. United States, 255 F.3d 1357 (Fed. Cir. 2001). In so doing, however, the court did not deviate from the standards enunciated above. The regulation at issue was promulgated under section 1502 and involved affiliated corporations filing consolidated returns. The court invalidated the regulation on the ground that its "duplicated loss factor distorts rather than reflects the tax liability of consolidated groups and contravenes Congress' otherwise uniform treatment of limiting deductions for the subsidiary's losses." 255 F.3d at 1360. In essence, the court held that denying the deduction at issue would impose a tax on income that would otherwise not be taxed. The regulation at issue here does not deny a deduction; it merely defers the deduction to a later taxable year.

[5]Section 1.451-1(a) provides that under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

implementing a statutory amendment to section 461 cannot extend to costs that will be included in inventoriable costs and cost of goods sold.[6]

The regulations are consistent with the congressional intent underlying the economic performance rules of § 461(h).

Reg. § 1.461-1(a)(2)(i) is a legislative regulation promulgated under section 461(h), which clearly authorizes the Secretary to prescribe regulations that determine when economic performance occurs. This regulation provides that for purposes of implementing section 461(h), the term "liability" is defined in Reg. § 1.446-1(c)(1)(ii)(B). Because the definition of the term "liability" is integral to the economic performance rules, the grant of authority under section 461(h) extends to the regulations, § 1.446-1(c)(1)(ii)(B), where the term is actually defined.

Even if Reg. § 1.446-1(c)(1)(ii) were not legislative, the regulation is valid because it meets the standards set for evaluating regulations that are not promulgated pursuant to a specific grant of authority. It is consistent with all the other relevant regulations and with section 461(h).

Congress' intent that the economic performance requirement pertains to liabilities is clearly expressed in the statute itself. The plain language of section 461(h) contradicts Taxpayer. The section is titled "Certain liabilities not incurred before economic performance." Subsection (h)(2), which states when economic performance occurs, refers to "liabilities" *five* times. The section does not mention expenses or deductions, and does not itself define "liabilities."

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[6]Taxpayer cites B.C. Cook & Sons, Inc. v. Commissioner, 65 T.C. 422 (1975), nonacq. 1977-1 C.B. 2, aff'd 584 F.2d 53 (5th Cir. 1978); Molsen v. Commissioner, 85 T.C. 485 (1985); Max Sobel Wholesale Liquors v. Commissioner, 69 T.C. 477 (1977), aff'd 630 F.2d 670 (9th Cir. 1980) for the proposition that cost of goods sold is an exclusion from gross income rather than a deduction. None of these cases, however, support the proposition that the Service may not promulgate regulations under §§ 263A and 446 that determine when costs are includible in inventoriable costs and ultimately cost of goods sold. The B.C. Cook courts held that amounts included in and recovered through cost of goods sold were not "deductions" within the meaning of section 1312(2). Although the Molsen court rejected the Service's argument that costs may not be included in cost of goods sold computation before the all-events test was met, the year at issue (1977) was prior to the effective date of § 461(h) and §§ 1.446-1(c)(1)(ii) and 1.263A-1(c)(2)(ii). The Max Sobel courts concluded that section 162(c)(2), which permanently disallowed deductions for illegal payments, did not apply to gross income exclusions, including sales discounts, rebates, and cost of goods sold.

When the regulations under 461 were proposed, commentators argued that the proposed regulations incorrectly applied section 461(h) to cost of goods sold. The Service and Treasury addressed the commentators' arguments in Treasury Decision 8408. The Treasury Decision points out that the old all-events test contained in Reg. § 1.461-1(a)(2) expressly applied to deductible expenses. Congress deliberately extended the reach of the economic performance requirement by amending section 461(h) to refer to "any item" that is incurred. Further, the "legislative history contemplates the application of the economic performance rules to capital items or other items that are not deductible in the year incurred." See H.R. No. 432 Part 2, 98th Cong., 2d Sess. 1254-55 (1984) (describing the difficulty of applying a discounting mechanism to capital items); see also Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong. 2d. Sess. 262 (1984) (providing an example applying the economic performance rules to highway construction costs, which in 1984 were ordinarily treated as deferred costs). T.D. 8408, 1992-1 C.B. 155.

The Tax Court has on numerous occasions cited Reg. § 1.446-1(c)(1)(A) and (B) as applicable law. For example, both Kroger Company v. Commissioner, T.C. Memo. 1997-2, and Dayton Hudson Corporation v. Commissioner, T.C. Memo. 1997-260 favorably cite § 1.446-1(c)(1)(ii)(A) and state that the term "liability" is defined in § 1.446-1(c)(1)(ii)(B).

Further support for the validity of the regulations is found in the Conference Report on the Deficit Reduction Act of 1984. When describing present law, that is, the pre-DRA '84 law, the report speaks in terms of expenses and deductions. When describing the changes in the law, the report speaks in terms of amounts "incurred" and "liabilities." H.R. No. 98-861, 98th Congress, 2nd Sess., 871-872; 1984-3 C.B. Vol. 2 125-126. Thus, it is evident from the legislative history that Congress intended the focus to be on the broader term "liabilities" rather than the narrower concept of deductions.

Clearly, Congress had the authority to defer the inclusion of costs in a taxpayer's inventoriable costs and cost of goods sold until those amounts satisfied the all-events test and the economic performance rules. Furthermore, the Service had the authority to so interpret the Code when it promulgated Reg. § 1.263A-1(c)(2)(ii), which provides that "[t]he amount of any cost required to be capitalized under section 263A may not be included in inventory . . . any earlier than the taxable year during which the amount is incurred within the meaning of § 1.446-1(c)(1)(ii)."

The regulations are consistent with the Commissioner's wide discretion under §§ 446 and 471 to determine whether a particular method of accounting clearly reflects income.

In the early 1980s, it was widely reported that because of the time value of money, a taxpayer that was found liable for torts could be better off from an income tax perspective than if it were found not liable. See e.g., McGown, "Structured Settlements: Deduct Now and Pay Later", 60 Taxes 251 (1982). This was true because the settlement of the claim could call for payments to be made over a long period, but the taxpayer could deduct the entire liability in the year that the settlement was reached. This fact pattern is exemplified in Ford Motor Co. v. Commissioner, 102 T.C. 87 (1994), aff'd 71 F.3d 209 (6th Cir. 1995).

In an attempt to prevent this and other distortions arising from liabilities that would not be performed until far into the future, Congress considered various alternatives, including discounting deductions and deferring deductions. H.R. No. 432 Part 2, 98th Cong., 2d Sess. 1254-55 (1984). Congress decided to defer deductions until "economic performance" occurred and enacted § 461(h). Section 461(h) was effective for taxable years after the date of enactment.

Moreover, at about this same time (1986), Congress enacted the uniform capitalization rules under section 263A. These rules were intended to prevent distortions of income from arising because in some cases the costs of producing or reselling property were permitted to be deducted currently rather than properly matched with the future income associated with that property. However, Congress did not make all producers or resellers subject to section 263A. For example, section 263A does not apply to resellers that meet a $10 million gross receipts exception. Accordingly, the regulations under sections 446 and 263A (Reg. §§ 1.446-1(c)(ii)(A) and 1.263A-1(c)(2)(ii)) reflect the fact that the timing rules that relate to costs of producing or reselling property should be the same regardless of whether a taxpayer incurs *deductible* or *inventoriable* costs.[7]

Meanwhile, the IRS continued to pursue cases like Ford Motor Co. based on a clear reflection of income theory. The Service prevailed in the Tax Court and the Sixth Circuit on the clear reflection of income theory. (The years at issue in Ford Motor Co. preceded the effective date of § 461(h).) Thus, the Service has previously

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[7]In Thor Power Tool, the Supreme Court recognized that §§ 446 and 471 provide the Commissioner with wide discretion in determining whether a particular method of accounting clearly reflects income. Section 471 regulations cross-reference section 263A and the regulations thereunder. Section 263A regulations preclude including a cost in inventoriable cost prior to the date that economic performance is satisfied.

litigated this issue exclusively on its section 446 authority. Both the Tax Court and the Sixth Circuit held that current deduction of a cost that will not satisfy economic performance until long into the future does not clearly reflect income. See Ford Motor Co. Presumably, the wide discretion enjoyed by the IRS under both § 446 and § 471 provides ample support for the similar conclusion that currently recovering the same or similar costs through inventory and cost of goods sold also does not clearly reflect income. If the method doesn't clearly reflect income, the regulations at issue are a valid exercise of the Commissioner's discretion to determine whether a particular method clearly reflects income.

Finally, the regulations are consistent with congressional disapproval in § 461(h) of reducing taxable income by recovering costs prior to economic performance. The contrary conclusion would emasculate § 461(h) for a significant segment of taxpayers (manufacturers and resellers). Moreover, because product liability claims arising from defectively manufactured or designed products are arguably costs incurred by reason of a production activity, a conclusion that inventoriable costs are not subject to the economic performance requirement would nullify the holdings in Ford Motor Co.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Taxpayer's arguments are without merit. We nonetheless are keenly interested whenever the validity of a regulation is challenged. Please keep the National Office apprized of the progress of this case.

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

Please call if you have any further questions.

HEATHER MALOY

By: ______________________________

JEFFERY G. MITCHELL
Senior Technician Reviewer, Branch 7
CC:ITA:B07