INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

March 15, 2006

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 263A.07-00
CASE-MIS No.: TAM-151284-05

Number: **200627025**
Release Date: 7/7/2006

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

a =

b =

c =

d =

ISSUE:

Whether a taxpayer is prohibited from using an estimating technique to compute the adjustment required by IRC § 481(a) when it voluntarily changes its method of accounting for costs under IRC § 263A with respect to non-inventory property.

CONCLUSION:

When an estimating technique is necessary to compute the adjustment required by IRC § 481(a) and the technique chosen results in an appropriate adjustment based on the facts and circumstances, a taxpayer may use the technique to compute its adjustment when it voluntarily changes its method of accounting for costs under IRC § 263A with respect to non-inventory property.

FACTS:

Taxpayer is engaged in the production, transmission, distribution, and sale of *a*. Taxpayer is also involved in the distribution of *b*. In connection with its business, Taxpayer produces self-constructed assets ("non-inventory property") that are subject to the capitalization rules of IRC § 263A. The cost of this property is depreciated in accordance with IRC § 168.

Taxpayer voluntarily changed its accounting method for the *c* tax year with regard to its non-inventory property contained in its *a* business. Specifically, Taxpayer elected to use the simplified service cost method described in Treas. Reg. § 1.263A-1(h) with the production based allocation ratio described in Treas. Reg. § 1.263A-1(h)(5). Taxpayer also elected to use the 90/10 *de minimis* rule of Treas. Reg. § 1.263A-1(g)(4)(ii). Lastly, Taxpayer ceased capitalizing certain deductible service costs that it had previously capitalized and began to capitalize certain production costs that it had previously incorrectly failed to capitalize. To implement this accounting method change, Taxpayer timely filed a Form 3115, Application for Change in Accounting Method, using the automatic consent procedures of Rev. Proc. 2002-9, 2002-1 C.B. 327. An adjustment required by IRC § 481(a) was computed, as explained below, by Taxpayer.

Taxpayer's adjustment under IRC § 481(a) reflects a revaluation of its non-inventory property on hand at the beginning of the *c* tax year. Taxpayer computed two amounts, which it added to obtain its adjustment. The first amount was the sum of three numbers reflecting the amount that was duplicated or omitted because of Taxpayer's accounting method change in each of the three years immediately prior to *c* tax year. The appropriateness of this amount is not in dispute. Taxpayer's second amount was the sum of the numbers reflecting the estimated amount that was duplicated or omitted because of its accounting method change in each tax year from 1987 through *d*. The appropriateness of this amount is in dispute.

To calculate the amount now in dispute, Taxpayer determined the difference between the amount of costs that were capitalized to non-inventory property under the old method and the amount that would have been capitalized under the new method in each of the three years immediately prior to the *c* tax year. Each of these differences was divided by the corresponding year's construction expenditures to obtain a change-in-capitalization ratio and from these three ratios; a weighted average percentage was computed. Taxpayer then multiplied its construction expenditure for each tax year from 1987 through *d* by that weighted average percentage to calculate its estimate of the amount that was capitalized to non-inventory property under the old method and the amount that would have been capitalized under the new method. Taxpayer allocated the aggregate difference for each year among the categories of assets that it constructed and determined how much of the difference had already been recovered through depreciation or dispositions during the time between the tax year and the *c* tax year. Taxpayer reduced the total difference in amount capitalized under the old and new methods by the amount that had already been recovered through depreciation and dispositions under the old method. Taxpayer treated the result as the adjustment under IRC § 481(a) attributable to non-inventory property produced between 1987 and the *d* tax year.

The director is examining Taxpayer's federal income tax return for the *c* tax year, and as part of this examination, the director is investigating whether Taxpayer has correctly determined the adjustment under IRC § 481(a) associated with its accounting method change. Specifically, Taxpayer's ability to use an estimating technique for the tax years from 1987 through *d* to obtain that part of its adjustment under IRC § 481(a) is questioned.

The director's initial concern is whether actual data exist, that would moot the need for Taxpayer to use any estimating technique. This disagreement is not addressed in this Technical Advice Memorandum; whether the necessary data exist is a factual decision left to the director. For this Memorandum, data is assumed not to exist and that Taxpayer is not able to compute the amount that had been duplicated or omitted for the tax years from 1987 through *d* in the same manner it did for the three years immediately prior to the *c* tax year. With this assumption, the director's second concern is reached, that is, whether Taxpayer is precluded by Treas. Reg. § 1.263A-7(d) from estimating the amount duplicated or omitted for the tax years from 1987 through *d*. Taxpayer and the director agree that the amount estimated is significant by size when compared to Taxpayer's total adjustment under IRC § 481(a) and the revalued non-inventory property.

LAW AND ANALYSIS:

IRC § 481(a) provides that, when taxable income is computed using an accounting method different from the method used to compute taxable income for the preceding tax year, the taxpayer must take into account the adjustments necessary to prevent amounts from being duplicated or omitted solely as a result of the change in accounting method.

Treas. Reg. § 1.263A-7 provides guidance to taxpayers changing their accounting methods for costs subject to IRC § 263A. In particular, this section provides guidance regarding how taxpayers are to revalue property on hand at the beginning of the tax year in which they change their accounting method for costs subject to IRC § 263A.

Treas. Reg. § 1.263A-7(c) concerns taxpayers changing accounting methods for costs subject to IRC § 263A with respect to inventory property. The inventory on hand at the beginning of the year of change must be revalued and an adjustment under IRC

§ 481(a) computed. The adjustment equals the difference between the inventory as originally valued under the former accounting method and the inventory as revalued using the new accounting method. One acceptable revaluation method is the facts and circumstances revaluation method.

The facts and circumstances revaluation method provided by Treas. Reg. § 1.263A-7(c)(2)(iii) requires a taxpayer to revalue its inventory by applying the capitalization rules of IRC § 263A and the appropriate Treasury Regulations to its production and resale activities with the same degree of specificity as required of inventory manufacturers immediately prior to the effective date of IRC § 263A. One of the acceptable estimating techniques specified is the use of available information from more recent years to estimate the amount of costs applicable in earlier years.

Another revaluation method for inventory mentioned in the Treasury Regulations is the weighted average method described in Treas. Reg. § 1.263A-7(c)(2)(iv). To use this method, a taxpayer must use the first-in, first-out (FIFO) method or the specific goods last-in, first-out (LIFO) method to account for its inventory. The availability of the method is further restricted to situations where the data is missing so that the facts and circumstances revaluation method provided by Treas. Reg. § 1.263A-7(c)(2)(iii) could not be used. A taxpayer using this method revalues its inventory using the weighted average percentage increase (or decrease) of additional costs.

The last acceptable revaluation method described by the Treasury Regulations for inventory is the 3-year average method described in Treas. Reg. § 1.263A-7(c)(2)(v). To use this method, a taxpayer must use the dollar-value LIFO method to account for its inventory. A taxpayer eligible to use this method revalues its existing LIFO layers by applying the average percentage change in the current costs of inventory for each LIFO pool based on the three most recent tax years for which the taxpayer has sufficient information to all of the pool layers.

Treas. Reg. § 1.263A-7(d) concerns taxpayers changing accounting methods for costs subject to IRC § 263A with respect to non-inventory property. Similar to Treas. Reg. § 1.263A-7(c), the property on hand at the beginning of the year of change must be revalued and an adjustment under IRC § 481(a) computed. The adjustment under IRC § 481(a) equals the difference between the basis of the property as originally valued using the taxpayer's former accounting method and the basis of the property as revalued using the taxpayer's new accounting method. The facts and circumstances revaluation method provided for inventory changes in Treas. Reg. § 1.263A-7(c)(2)(iii) must be used to revalue the non-inventory property.

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

described in the Appendix of the revenue procedure. An accounting method change made using the automatic consent procedures is subject to the usual post-filing review process. Included in the review of the accounting method change is whether the amount of the adjustment under IRC § 481(a) was properly determined and the director will revise the adjustment when the director determines that it has not been properly computed. See sections 9.01(2) and 9.02(3) of Rev. Proc. 2002-9.
The director is reviewing Taxpayer's adjustment under IRC § 481(a). Taxpayer has satisfied the director that the portion of its adjustment relating to the three tax years immediately prior to the *c* tax year is reasonable and appropriate. However, the director questions the remainder of Taxpayer's adjustment, *i.e.*, the amount determined for property produced between 1987 and the *d* tax year. Taxpayer used an estimating technique and not actual data to determine this amount, and the director questions whether Taxpayer is barred from doing so by Treas. Reg. § 1.263A-7(d).

Treas. Reg. § 1.263A-7(d) requires that the facts and circumstances revaluation method of Treas. Reg. § 1.263A-7(c)(2)(iii) be used to revalue Taxpayer's non-inventory property on hand at the beginning of the *c* tax year so that the adjustment under IRC § 481(a) can be computed. This method requires a taxpayer to revalue its property by applying the capitalization rules of IRC § 263A and the appropriate Treasury Regulations to its production and resale activities with the same degree of specificity as required of manufacturers immediately prior to the effective date of IRC § 263A. Treas. Reg. § 1.263A-7(c)(2)(iii) recognizes that often taxpayers will need to use estimates and estimation procedures to revalue property, even in the context of a facts and circumstances methodology.

Treas. Reg. § 1.263A-7(c) was written principally for taxpayers required to revalue inventory property under IRC § 263A. Taxpayers may use the facts and circumstances method to revalue inventory property under IRC § 263A, except where the taxpayer has to estimate part of the adjustment because the taxpayer does not have adequate books and records to compute the actual adjustment and the amount of the adjustment that must be estimated is significant in comparison to the total restated value of the inventory. In those instances, Treas. Reg. § 1.263A-7(c)(2)(iii)(B) provides that the taxpayer must revalue inventory using the method prescribed by paragraph (c)(2)(iv) or (c)(2)(v).

We do not believe that the exception to the facts and circumstances revaluation method for inventory property in Treas. Reg. § 1.263A-7(c)(2)(iii) applies to non-inventory property, which, according to Treas. Reg. § 1.263A-7(d), must be revalued using the facts and circumstances method. Therefore, we believe that a taxpayer may use estimates and procedures that are reasonable considering its facts and circumstances to revalue non-inventory property consistent with the facts and circumstances revaluation method.

Moreover, we believe that Treas. Reg. § 1.263A-7 does not require a taxpayer making a voluntary accounting method change to use a cutoff method where the taxpayer is able to use reasonable estimates and procedures to determine the amount of the IRC § 481(a) adjustment. Even where taxpayers are required to use the weighted average method or the 3-year average method, Treas. Reg. § 1.263A-7 contemplates that estimates and procedures will be used to revalue the inventory and compute the IRC § 481(a) adjustment. Thus, it is clear that under all circumstances, taxpayers are permitted, or even required, to use some estimates and procedures to revalue inventory and compute an adjustment under IRC § 481(a). To interpret the interaction of Treas. Reg. § 1.263A-7(c)(2)(iii) and § 1.263A-7(d) otherwise would deprive some taxpayers and the Internal Revenue Service from the ability to compute reasonable and appropriate adjustments under IRC § 481(a) for costs capitalized to non-inventory property.

The fact that Taxpayer had to estimate a significant part of its adjustment under IRC § 481(a) does not compel the director to reject Taxpayer's estimating technique. While the size of the IRC § 481(a) adjustment computed by Taxpayer may have led to a closer examination of Taxpayer's estimating technique by the director than otherwise would have occurred, the size does not restrict Taxpayer's ability to use reasonable estimates and procedures to revalue non-inventory property. The appropriateness of the estimates and procedures will be determined during the post-filing review of Taxpayers' tax returns. Taxpayer must prove to the director that its estimates and procedures are necessary, reasonable, and appropriate under its facts and circumstances.

CAVEAT:

A copy of this technical advice memorandum is to be given to Taxpayer. IRC § 6110(k)(3) provides that it may not be used or cited as precedent.