INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Number: **200843031**
Release Date: 10/24/2008

July 16, 2008

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 263A.03-04, 263A.06-05, 263A.07-00, 446.04-00, 446.04-05, 446.04-12
CASE-MIS No.: TAM-106547-08

Director
Large and Mid-Size Business

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =

Subsidiary = .

US Parent =

Foreign Parents =

Foreign Parent 1 =

Accountants 1 =

Accountants 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

Date 11 =

Date 12 =

Date 13 =

Date 14 =

Date 15 =

Date 16 =

Date 17 =

Date 18 =

Date 19 =

Date 20 =

Month 1 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Food =

Amount 1 =

ISSUE:

Whether Taxpayer's method of accounting for royalty expense was an issue under consideration, within the meaning of Rev. Proc. 97-27, 1997-1 C.B. 680 (as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432), when Taxpayer filed Form 3115 requesting consent to change its method of accounting for royalty expense on Date 1.

CONCLUSION:

Taxpayer's method of accounting for royalty expense was an issue under consideration, within the meaning of Rev. Proc. 97-27, when Taxpayer filed Form 3115 requesting consent to change its method of accounting for royalty expense on Date 1.

FACTS:

For purposes of this memorandum, Taxpayer refers to a U.S. affiliated group of corporations engaged in the business of manufacturing Food products for retail, food service and industrial markets in the United States. Taxpayer produces tangible personal property for sale to customers, within the meaning of § 1.263A-2(a)(1) of the Income Tax Regulations. Taxpayer files a consolidated federal income tax return using a tax year ending Date 2. Taxpayer is owned by Foreign Parents. Taxpayer licensed certain Food-making technology from Foreign Parent 1 under an agreement which provided that Taxpayer was to pay Amount 1 as a royalty fee for the tax year ended Date 3, and that the amount of the fee would be adjusted following the completion of a transfer pricing study. After the study was completed, Taxpayer filed a request for an Advance Pricing Agreement ("APA") to determine the deductible portion of the royalty expense paid by Taxpayer to Foreign Parent 1. The APA was executed on Date 4.

Taxpayer's federal income tax return for its Year 1 tax year was placed under examination on Date 5. On Date 7, an Internal Revenue Agent (Agent 1) hand

delivered to Taxpayer an Initial Contact Letter and Opening Conference Letter to include the Year 2 tax year return in the examination of the Year 1 tax year return. Agent 1 sent an email to Taxpayer on Date 8, stating in relevant part:

> Our revised plan is to add only the Year 2 tax year to the current examination and do a very limited examination. The issues for which we have currently identified adjustments will be looked at again, in addition, the royalty expense will be included in our exam plan.

A conference call was held on Date 9. The parties do not agree as to what occurred during the call. The Examination Team represents that Agent 1 addressed the royalty expense issue and informed Taxpayer that the Examination Team was considering including the capitalization of royalties with respect to § 263A in the audit plan for the Year 2 tax year. Taxpayer does not agree that it was so informed. Agent 1's notes from the call state: "APA signed Date 10. 90 days to file Annual Report. Goes back to Year 2 tax year Royalty Expense. Transfer Pricing Review by Accountants 1." The parties agree that Agent 1's notes were not provided to Taxpayer prior to its filing of Form 3115.

In a meeting held on Date 11 at Taxpayer's U.S. office, Agent 1 informed Taxpayer that the royalty expense issue would not be included in the Year 2 tax year examination. Taxpayer represents that the Examination Team's reference to "the royalty expense issue" was understood by Taxpayer to refer to the APA and the determination of the appropriate amount of royalty expense. The parties do not agree as to the remainder of what occurred during the meeting. The Examination Team represents that Agent 1 also informed Taxpayer that the royalty expense issue would be considered in the next cycle. Agent 1's notes from this meeting specifically state: "royalty expense 263A-Year 3? Include or not." Taxpayer represents that at no time during the Date 11 meeting did the Examination Team inform Taxpayer that it was considering examining the issue of Taxpayer's method of accounting for the royalty expense as an inventoriable cost under § 263A. Taxpayer further represents that it was not informed that Agent 1's notes included the words "royalty expense 263A." The parties agree that Agent 1's notes were not provided to Taxpayer prior to its filing of Form 3115.

The examination of Taxpayer's tax return for the Year 2 tax year ended, within the meaning of section 3.07(1) of Rev. Proc. 97-27, on Date 12. The Year 2 cycle was sent to case processing as agreed on Date 13. The Year 1 cycle was sent to case processing as partially agreed, and was to be forwarded to Appeals.

On Date 14, another Internal Revenue Agent (Agent 2) issued an Information Document Request, IDR General-001, to Taxpayer. IDR General-001 covered tax years Year 4 and Year 5. Item 9 of the IDR states: "Please provide the year-end inventory workpapers for Year 4 and Year 5." Item 10 states: "Please provide the year-end 263A workpapers for Year 4 and Year 5."

The Opening Conference for the Year 4 and Year 5 audit cycle occurred on Date 15 at Taxpayer's offices. During the meeting, the Examination Team issued an examination timeline to Taxpayer, informing Taxpayer that the Examination Team would complete the draft audit plan for Year 4 and Year 5 by Date 16. The parties do not agree as to what else occurred or was discussed during the meeting.

On Date 17, Taxpayer sent an email to the Examination Team Manager and Agent 2 to request a conference call to discuss a potential change in accounting method. After receiving this email, the Team Manger participated in a conference call with Taxpayer and Taxpayer's Representative from Accountants 2 to discuss the potential change in accounting method. During the call, Taxpayer stated that it wished to submit a Form 3115 with respect to the capitalization of royalties under § 263A and the regulations thereunder. The Team Manger informed Taxpayer that it could not submit a Form 3115 for this issue because the issue was "under consideration." The parties do not agree as to subsequent events during the conference call.

On Date 1, Taxpayer submitted a Form 3115, Application for Change in Accounting Method ("Form 3115"), seeking permission to change its method of accounting for royalty expense under § 263A for its taxable year ending Date 6. The Form 3115 was filed during the 90-day window period pursuant to section 6.01(2) of Rev. Proc. 97-27, 1997-1 C.B. 680 (as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432). The Team Manager received a copy of the Form 3115 on Date 16.

On Date 16, the Team Manager issued a draft of the audit plan for Year 4 and Year 5 to Taxpayer. Included in the audit plan was a risk analysis worksheet indicating that the Examination Team would examine the royalty issue with respect to capitalization under § 263A.

On Date 18, the Examination Team issued a Notice of Proposed Adjustment to Taxpayer for Year 4 and Year 5, which informed Taxpayer that the capitalization of royalties under Section 263A was an issue under consideration for purposes of Rev. Proc. 97-27 and that the Examination Team had informed the appropriate branch of the National Office of Chief Counsel (Income Tax and Accounting) that it considered the capitalization of royalties under Section 263A to be an issue under consideration and had requested that the National Office suspend the processing of Taxpayer's Form 3115.

Taxpayer filed an Appeals Protest with the Chicago Appeals Office on Date 19. Representatives of Taxpayer met with the Appeals Officer on Date 20 to discuss the Protest. In Month 1, the Appeals Officer returned the case to the Examination Team with the recommendation that Taxpayer be afforded its conference of right with the

National Office through the submission of a request for a Technical Advice Memorandum.

LAW:

Section 446(e) provides that, except as otherwise expressly provided in Chapter 1 of the Code, 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 1.446-1(e)(2)(i) provides that, except as otherwise expressly provided in Chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Code or regulations thereunder.

Section 1.446-1(e)(3)(ii) provides that the Commissioner may prescribe administrative procedures under which taxpayers will be permitted to change their methods of accounting. The administrative procedures shall prescribe those terms and conditions necessary to obtain the Commissioner's consent to effect the change and to prevent amounts from being duplicated or omitted.

Section 1.263A-1(a)(3) provides that taxpayers subject to section 263A must capitalize all direct costs and certain indirect costs properly allocable to (A) real property and tangible personal property produced by the taxpayer, and (B) real property and personal property described in section 1221(1) which is acquired by the taxpayer for resale.

Section 1.263A-1(c)(1) provides that in order to determine capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production or resale activities. After § 263A costs are allocated to the appropriate production or resale activities, these costs generally are allocated to the items of property produced during the taxable year and capitalized to the items that remain on hand at the end of the taxable year.

Section 1.263A-1(e)(3) provides that indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities.

Section 1.263A-1(e)(3)(ii)(U) provides that licensing and franchise costs, including fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced or property acquired for resale, are examples of indirect costs that must be

capitalized to the extent they are properly allocable to property produced or property acquired for resale.

Section 1.263A-2(a) provides that section 263A applies to real property and tangible personal property produced by a taxpayer for use in its trade or business or for sale to its customers.

Section 1.263A-2(a)(1)(i) provides that for purposes of section 263A, the term “produce” includes construct, build, install, manufacture, develop, improve, create, raise, or grow.

Rev. Proc. 97-27 contains the general procedures under section 446(e) for taxpayers seeking to obtain the advance consent of the Commissioner to change a method of accounting.

Section 1.02(1) of Rev. Proc. 97-27 states that the revenue procedure provides incentives to encourage prompt voluntary compliance with proper tax accounting principles by providing more favorable terms and conditions if the taxpayer files its request for a change in accounting method before the Service contacts the taxpayer for examination. A taxpayer under examination may request permission to change a method of accounting under limited circumstances.

Section 6.01(2) provides that a Form 3115 may be filed during the first 90 days of any taxable year ("90-day window") if (1) the taxpayer has been under examination for at least 12 consecutive months as of the first day of the taxable year, and (2) the method of accounting the taxpayer is requesting to change is not, at the time the Form 3115 is filed, an issue under consideration or an issue the examining agent has placed in suspense.

Section 3.08(1) provides that a taxpayer's method of accounting for an item is an issue under consideration for the taxable years under examination if the taxpayer receives written notification (for example, by examination plan, information document request (IDR), or notification of proposed adjustments or income tax examination changes) from the examining agent(s) specifically citing the treatment of the item as an issue under consideration. For example, a taxpayer's method of pooling under the dollar-value, last-in, first-out (LIFO) inventory method is an issue under consideration as a result of an examination plan that identifies LIFO pooling as a matter to be examined, but it is not an issue under consideration as a result of an examination plan that merely identifies LIFO inventories as a matter to be examined. Similarly, a taxpayer's method of determining inventoriable costs under § 263A is an issue under consideration as a result of an IDR that requests documentation supporting the costs included in inventoriable costs, but it is not an issue under consideration as a result of an IDR that requests documentation supporting the amount of cost of goods sold reported on the return. The question of whether a method of accounting is an issue under consideration may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 2001-

2, 2001-1 I.R.B. 79 (or any successor).

ANALYSIS:

Change in Method of Accounting

Taxpayer filed Form 3115 to request consent to change its method of accounting for royalty expenses for its taxable year ending Date 6 under the 90-day window provision of section 6.01(2) of Rev. Proc. 97-27. Taxpayer had been under examination for at least 12 consecutive months as of the first day of its taxable year ending Date 6. However, the 90-day window provision would not be available to Taxpayer if its method of accounting for royalty expense was an issue under consideration within the meaning of section 3.08(1) of Rev. Proc. 97-27, when Taxpayer filed the Form 3115 on Date 1.

Under section 3.08(1), a taxpayer's method of accounting for an item is an issue under consideration for the taxable years under examination if (1) the taxpayer receives written notification from the examining agent(s) and (2) the written notification specifically cites the treatment of the item as an issue under consideration. Two written documents were received by Taxpayer from the examination team before the filing of the Form 3115 on Date 1 - the e-mail sent by Agent 1 to Taxpayer on Date 8, and IDR General-001, issued by Agent 2 to Taxpayer on Date 13. We find that IDR General-001 is, in itself, sufficient notification that the method of accounting used by Taxpayer to account for royalty costs was an issue under consideration.

Section 3.08(1) expressly identifies an Information Document Request (IDR) as being one type of document that may constitute written notification for purposes of Rev. Proc. 97-27. To provide such written notification, an IDR must specifically cite the treatment of an item as an issue under consideration. Rev. Proc. 97-27 does not define the term “specifically citing”. Nor does it provide criteria that an IDR must meet in order to be seen as specifically citing the treatment of an item. Instead, it provides two narrow examples to illustrate when the language in a document specifically cites (or does not specifically cite) the treatment of an item as an issue under consideration in a manner sufficient to place a taxpayer's method of accounting for that item under consideration. In the second example, a taxpayer's method of determining inventoriable costs under section 263A is an issue under consideration as a result of an IDR that requests documentation supporting the costs included in inventoriable costs. Thus, the second example stands for the proposition that an IDR that requests documentation supporting an item is specifically citing the treatment of that item as an issue under consideration.

The term "item," refers to a class or type of revenue or expense to which a method of accounting applies. *See* TAMS 200718030 and 200738014. The item at issue here is the costs capitalized to inventory under § 263A by Taxpayer. In Item 10, IDR General-001 asked Taxpayer to "provide the year-end 263A workpapers for Year 4 and Year 5”. A request for copies of papers supporting how costs were identified and added to the

tax basis of property is a request for documentation supporting the costs capitalized under § 263A. *See* TAM 9747006. A taxpayer's "year-end 263A workpapers" are the type of papers that would reasonably be expected to contain information necessary to support how costs are identified and added to the tax basis of inventory in compliance with § 263A. Thus, by requesting Taxpayer's year-end § 263A workpapers, IDR General-001 specifically cites the treatment of costs under § 263A by Taxpayer for the tax years Year 4 and Year 5 as an issue under consideration, within the meaning of section 3.08(1). Since IDR General-001 constitutes written notification to Taxpayer specifically citing the treatment of costs under § 263A as an issue under consideration, Taxpayer's method of accounting for capitalizing costs to inventory under § 263A for tax years Year 4 and Year 5 was an issue under consideration, within the meaning of section 3.08(1).

Under § 263A and the regulations thereunder, a taxpayer that produces tangible personal property for sale to its customers must capitalize all direct costs and a properly allocable share of indirect costs to its inventory. As described in § 1.263A-1(c)(1), in order to capitalize the proper amount of costs to inventory, a taxpayer must make two cost allocations, using two allocation methods. Taxpayers must (1) allocate or apportion costs to various activities, including production activities (determining inventoriable costs), and (2) taxpayers must allocate the costs assigned to production activities to the items of inventory produced during the taxable year (allocating inventoriable costs to inventory).[1] Accordingly, for purposes of section 3.08(1), a cite to a taxpayer's treatment of costs under § 263A would include both of the required cost allocations, and the taxpayer's method of accounting for capitalizing costs to inventory under § 263A would include both its method of determining inventoriable costs and its method of allocating inventoriable costs to inventory. Because the treatment of the item specifically cited as an issue under consideration by Item 10 of IDR General-001, costs capitalized under § 263A by Taxpayer, includes the determination of inventoriable costs, Taxpayer's method of determining inventoriable costs, as well as Taxpayer's method of allocating inventoriable costs to inventory, was an issue under consideration, within the meaning of section 3.08(1).

Section 1.263A-1(e)(3)(ii)(U) specifically identifies royalty costs incurred by a licensee or a franchisee that are associated with the production of property as an example of indirect costs that must be capitalized to inventory. Because we find that IDR General-001 is, in itself, sufficient notification that Taxpayer's method of determining inventoriable costs was an issue under consideration, we also conclude that IDR

[1] The method used in making the first cost allocation required under the § 263A regulations, allocating or apportioning costs among various activities, is referred to in the second example in section 3.08(1) as the "method of determining inventoriable costs under § 263A". To provide consistency, the method used in making the first cost allocation is referred to in this memorandum as the "method of determining inventoriable costs". The method used in making the second cost allocation required under the § 263A regulations, allocating the costs assigned to production activities to the items of property produced during the taxable year, is referred to as the "method of allocating inventoriable costs to inventory".

General-001 is, in itself, sufficient notification that Taxpayer's method of determining inventoriable, or non-inventoriable, royalty expenses was an issue under consideration. Since IDR General-001 was issued prior to the date on which Taxpayer filed the Form 3115, the method of accounting for royalty costs for which Taxpayer sought consent to change was an issue under consideration at the time the Form 3115 was filed.

Taxpayer's Arguments

Taxpayer disagrees and argues that IDR General-001 does not place Taxpayer's method of accounting for royalties under consideration because the IDR fails to meet the requirements of section 3.08(1). From the examples in section 3.08(1) and from interpretations of the requirements under section 3.08(1) contained in legal advice previously provided by the Service, Taxpayer extracts the following principles: (1) in order to place an issue under consideration, a written notification must both (a) refer to a class or type of revenue or expense (an item) to which a method of accounting applies, and (b) specifically cite the taxpayer's method of accounting for that item, and (2) where the class of accounting methods identified is unreasonably broad in comparison to the matters purportedly placed under consideration, the "specificity" requirement of section 3.08(1) may not be met. Taxpayer argues that IDR General-001 fails to meet either of these principles.

1. The Written Notification

    a. IDR General-001 Does Not Identify Any Item

Applying the first requirement of its two-part standard, Taxpayer, relying primarily on FSA 2382, argues that IDR General-001 is a generic IDR issued at the commencement of an Audit and does not refer to an item. In FSA 2382, the Service found that the taxpayer's method of accounting for loan origination costs was an issue under consideration when the taxpayer received an IDR (IDR No. 2) which specifically identified the taxpayer's loan origination costs as an issue. The finding did not rely on an earlier-issued IDR (IDR No. 1) that requested information about the taxpayer's Schedule M-1 adjustment, even though the costs appeared as part of the taxpayer's Schedule M-1 adjustment. Here, Taxpayer analogizes IDR No. 1 in FSA 2382, requesting information about the taxpayer's Schedule M-1 adjustment, to IDR General-001, requesting Taxpayer's year-end 263A workpapers. We find Taxpayer's analogy to be unpersuasive in this situation.

We agree that when a taxpayer's Schedule M-1 contains numerous book-tax adjustments, an IDR, such as IDR No. 1 in FSA 2382, that merely requests information concerning the taxpayer's Schedule M-1 adjustments, would be insufficient, standing alone, to identify a specific item, such as the loan origination costs in FSA 2382, as an issue under consideration. Here, however, the workpapers requested by IDR General-001 contain information on only one item, the costs capitalized to inventory under

§ 263A by Taxpayer. The request for information on the taxpayer's Schedule M-1 in IDR No. 1 in FSA 2382 is simply not analogous to the request for § 263A workpapers in IDR General-001.

Based on TAM 200718030, Taxpayer also argues that because a taxpayer's § 263A workpapers could include every cost in the taxpayer's general ledger, IDR General-001 does not refer to any specific cost, and, thus, does not refer to any item. This argument is based upon an incorrect construction of the term "item" as being the same as the term "cost". As noted above, the term "item," refers to a class or type of revenue or expense to which a method of accounting applies. *See* TAMS 200718030 and 200738014. The item at issue here is the costs capitalized to inventory under § 263A, which is clearly a class or type of expense which is comprised of differing types of costs. We do not believe that in order to specifically cite the treatment of an item, the written notice is required include a reference to every cost that could be included in the item. See TAM 200738014.

b. IDR General-001 Does Not Specifically Refer to Taxpayer's Method of Accounting for Any Item

Taxpayer next argues that under the second prong of its two-part standard, IDR General-001 fails to meet the requirements of section 3.08(1) because it does not specifically refer to taxpayer's method of accounting for any item. Although the second element of Taxpayer's two-part standard refers to a taxpayer's method of accounting, Taxpayer appears to use the term "method of accounting" interchangeably with "treatment of the item". We believe that there is a clear distinction between the terms.

Under § 3.08(1), a written notice must specifically cite "the treatment" of an item as an issue under consideration in order to place the method of accounting for the item under consideration. The notice is not required to explicitly or correctly cite the particular "method of accounting" that taxpayer is actually or purportedly applying to the item. See TAM 200424004 and CCA 200718030. As discussed above, we believe that the item at issue here is the costs capitalized to inventory under § 263A and that the treatment of the item is specifically cited as an issue under consideration by Item 10 of IDR General-001.

2. The "Specificity" Requirement of Section 3.08(1)

Although it incorrectly reads section 3.08(1) as requiring a specific reference to a "method of accounting", rather than to the "treatment of the item", the essence of Taxpayer's argument is that the request for Taxpayer's year-end 263A workpapers for Year 4 and Year 5 in Item 10 of IDR General-001 does not cite Taxpayer's treatment of inventoriable costs under § 263A with a degree of specificity that Taxpayer feels necessary to identify its method of accounting for royalty expense as an issue under consideration. Taxpayer correctly states the principle that the specificity requirement of

section 3.08(1) can be violated if the class of accounting methods identified in the written notification is unreasonably broad with respect to the matters to be placed under consideration. *See* CCA 200718030. In reaching its conclusion that the class of accounting method identified by Item 10 of IDR General-001 is unreasonably broad, Taxpayer relies to a great extent on its categorization of its method of determining inventoriable costs under § 263A as a sub-method of its method of capitalizing costs to inventory under § 263A.

a. The Method/Sub-Method Rule

Taxpayer reads the examples in section 3.08(1) to require that whenever a method of accounting can be labeled a sub-method of another, hierarchical accounting method, a written notice that identifies the higher method is always unreasonably broad with respect to the treatment of the item under the sub-method and, therefore, always violates the specificity requirement of section 3.08(1). In other words, for a sub-method to be placed under consideration, section 3.08(1) requires that, in all cases, a written notification must specifically identify the particular sub-method. We do not believe that the language in section 3.08(1) imposes this requirement. Further, we do not believe that this requirement can be fashioned from the examples in section 3.08(1).

Although the use of illustrative examples can be useful in applying a rule to a set of facts, the underlying principles of the rule are not established or modified by accompanying examples. For example, generally, the language of a statute is not to be regarded as modified by examples set forth in the legislative history. Pension Ben. Guar. Corp. v. LTV Corp., 496 U.S. 633, 649, (1990). "An example, after all, is just that: an illustration of a statute's operation in practice. It is not…a definitive interpretation of a statute's scope." Id. Likewise, examples incorporated into Treasury Regulations are generally considered illustrative only and are not to be considered as dispositive. See Tennessee Baptist Children's Homes, Inc. v. U.S., 790 F.2d 534, (C.A.6 1986), Nico v. C.I.R., 565 F.2d 1234, 1238 (2d Cir.1977) (illustrative, hypothetical examples employing particular deductions did not contradict clear language of regulation); 1210 Colvin Avenue, Inc. v. United States, 81-1 U.S. Tax Cas. (CCH) ¶ 9474 at 87,383 (W.D.N.Y.1981) (definition of controlled corporation not limited to illustrative examples utilizing particular percentage figures regarding extent of control); Solomon v. C.I.R., 67 T.C. 379, 386 (1976) (examples in Treasury regulations portraying particular form of corporate reorganization in context of deferral payments are merely illustrative and do not purport to limit application of statute), aff'd, 570 F.2d 28 (2d Cir.1977), and aff'd sub nom. Katkin v. C.I.R., 570 F.2d 139 (6th Cir.1978). Here, the same is true. The examples accompanying section 3.08(1) are illustrative of the principles embodied in section 3.08(1), but they do not establish a requirement that in order for a method of accounting that may be described as a sub-method to be an issue under consideration, a written notification must, in all cases, specifically identify the lower sub-method.

This is illustrated by both the first example in section 3.08(1) (the LIFO example) and a previously issued Technical Advice Memorandum. The LIFO example states that a taxpayer's method of pooling under the dollar-value LIFO inventory method is an issue under consideration as a result of an examination plan that identifies LIFO pooling as a matter to be examined, but would not be considered an issue under consideration if the examination plan merely identifies LIFO inventories as a matter to be examined. However, in TAM 200142001, the Service issued an IDR to the taxpayer for the development of an examination plan. The IDR stated that "the Service hereby notifies you that it has identified the following LIFO accounting methods that are areas of potential adjustment:…Statement # 3: The method used by the taxpayer in the pooling of its LIFO inventory items/products under the dollar-value LIFO method...Statement # 4: The method used by the taxpayer in determining the number and composition of its inventory pools." Relying on the LIFO example, the TAM found that Statement #3 "places Taxpayer's method of pooling dollar-value LIFO inventories under consideration." In analyzing Statement #4, the TAM first clearly points out that because Statement #4 indicates that the examining agent plans to evaluate whether the taxpayer has the requisite number of pools, and whether the items in each pool belong in that pool, another existing pool, or a new pool, it is even "more specific [than Statement #3]." However, in this case, the TAM did not require a "more specific" reference to the sub-methods. It was enough that the hierarchical method, the taxpayer's method of pooling under the dollar-value LIFO inventory method, was an issue under consideration. As a result of the examination plan that identified LIFO pooling as a matter to be examined, the IDR placed the taxpayer's methods of determining the number of pools and assigning items to each pool under consideration.

The situation here is similar. The examining agents issued IDR General-001 to Taxpayer asking for "the year-end 263A workpapers for Year 4 and Year 5" as well as "the year-end inventory workpapers for Year 4 and Year 5." A taxpayer's year-end 263A workpapers are an example of documentation supporting the costs capitalized to inventory under § 263A. Typically, year-end 263A workpapers are prepared for the sole purpose of determining the additional § 263A costs that are required to be capitalized to inventory by a taxpayer. The workpapers can be expected to contain information on how inventoriable costs are identified and how those costs are then allocated to ending inventory, and the accounting methods used in making the underlying determinations and calculations. As a result, the IDR that requested taxpayer's year-end 263A workpapers identified Taxpayer's treatment of costs under § 263A as a matter to be examined and placed Taxpayer's accounting methods for determining inventoriable costs and for allocating inventoriable costs to inventory under consideration.

Applying the method/sub-method rationale to the facts at hand, Taxpayer compares IDR General-001 and its method of determining inventoriable costs under § 263A to the written notification and accounting methods described in the examples in section 3.08(1), and in legal advice previously provided by the Service that dealt with the requirements under section 3.08(1).

b. The examples in section 3.08(1) of Rev. Proc. 97-27,

i. The LIFO Example Analogy

Taxpayer's primary argument that IDR General-001 does not specifically cite its method of determining inventoriable costs under § 263A is centered on the LIFO example. Taxpayer asserts that as a sub-method, its method of determining inventoriable costs under § 263A is comparable to the taxpayer's method of pooling in the LIFO example. The LIFO example states that an examination plan that identifies "LIFO pooling" as a matter to be examined is sufficient to place a taxpayer's method of pooling under consideration, whereas an examination plan that merely identifies "LIFO inventories" as a matter to be examined is not.

In applying its method/sub-method rule, Taxpayer points to the levels of increasing specificity in the LIFO example: (1) LIFO inventories (specificity level 1) and (2) LIFO pooling (specificity level 2). Based on the LIFO example, a document using specificity level 1 language is insufficiently specific to place a specificity level 2 method of accounting under consideration. Referring to Item 10 of IDR General-001, Taxpayer then draws an analogy between the levels of increasing specificity it found in the LIFO example and the levels of increasing specificity it finds in the matter at hand: (1) capitalizing costs to inventory under § 263A, and (2) determining inventoriable costs under § 263A. Based on its comparison of the LIFO accounting methods in the LIFO example and the Taxpayer's § 263A methods, Taxpayer argues that Item 10 of IDR General-001 is insufficiently specific to place its method of determining inventoriable costs under § 263A (specificity level 2) under consideration, because it references only capitalizing costs to inventory under § 263A (specificity level 1). However, Taxpayer's analogy fails because the facts at issue and the LIFO example are materially different.

The LIFO example stands for the principle that the specificity requirement of section 3.08(1) can be violated if the class of accounting methods identified in the written notification is unreasonably broad with respect to the matters to be placed under consideration. See CCA 200718030. This principle is simply not applicable to Item 10 of IDR General-001, which identifies a class of accounting methods (the methods used to capitalize costs under § 263A) that is not unreasonably broad with respect to the matters that are placed under consideration (the costs capitalized under § 263A).

The use of the LIFO method, by allowing a taxpayer to allocate its earliest costs to ending inventory, is based on the assumption that during the taxable year, a taxpayer sells its most recently purchased goods while retaining its oldest goods in ending inventory. The rationale supporting the use of the LIFO method is that it results in a closer matching of current expenses to current income, since the cost of the last item of inventory is usually closer to the replacement cost of the item than is the price of the first item that was purchased. To determine the correct cost of the items in ending

inventory using the LIFO method requires skill, effort, and the application of numerous special accounting methods. The method appearing in the LIFO example, the dollar-value LIFO inventory method, is a complex system of inventory pricing characterized by a multiplicity of sub-methods (e.g., the pooling method, pricing method, method of determining current-year cost, and method of defining items). A written notification identifying "LIFO inventories" as a matter to be examined will encompass numerous diverse methods of accounting. As a result, to provide the notification required under section 3.08(1) to place a particular LIFO inventory sub-method under consideration, it may be reasonable to require a more specific reference to that sub-method.

This, however, is not the case with a taxpayer's method of capitalizing costs to inventory under § 263A. In contrast to the complexity of the LIFO inventory method and the plethora of LIFO sub-methods, a written inquiry requesting documentation on a taxpayer's method of capitalizing costs to inventory under § 263A can refer to only two interrelated sub-methods under § 263A - determining inventoriable costs and allocating those costs to items of inventory produced during the year. For these reasons, the method of capitalizing costs to inventory under § 263A at issue here is not analogous to the method of pooling in the LIFO example and, therefore, the LIFO example is irrelevant to the facts at issue.

ii. The Cost of Goods Sold (GOGS) Example

In the second example in section 3.08(1) (the COGS example), a taxpayer's method of determining inventoriable costs under § 263A is an issue under consideration as a result of an IDR that requests documentation supporting the costs included in inventoriable costs, but it is not an issue under consideration as a result of an IDR that requests documentation supporting the amount of cost of goods sold reported on the return. Although the sub-method of accounting at issue here is the same as the sub-method used in the COGS example, the method of determining inventoriable costs under § 263A, the item specifically cited in IDR General-001, costs capitalized to inventory under § 263A, is not analogous to the item cited in the IDR in the COGS example, the costs included in cost of goods sold and, therefore, the COGS example is also irrelevant to the facts at issue. The COGS example does, however, illustrate that to provide notice to a taxpayer that its method of determining inventoriable costs under § 263A is an issue under consideration, an IDR need not recite every possible expense or accounting method or sub-method that may be involved in determining inventoriable costs under § 263A.

c. TAM 200142001

As further support for its argument that IDR General-001 lacks the specificity required by section 3.08(1) to place Taxpayer's method of accounting for royalty expense under consideration, Taxpayer looks to interpretations of the requirements under section 3.08(1) contained in legal advice previously provided by the Service. In particular,

Taxpayer relies on the conclusions reached in TAM 200142001. We note that a Technical Advice Memorandum is directed to a specific taxpayer regarding a certain transaction or set of facts, and may not be cited or relied upon as precedent under section 6110(k)(3). In TAM 200142001, the Service examined an IDR that contained seven statements which identified various LIFO accounting methods as “areas of potential adjustment” to determine whether the taxpayer has been informed that a specific accounting method or sub-method would be examined. Taxpayer analogizes the request for § 263A workpapers in Item 10 of IDR General-001 to Statements 1, 2 and 7, which were found to be insufficiently specific to place other LIFO sub-methods under consideration. We believe that the conclusions reached in TAM 200142001 with regard to Statements 1, 2 and 7 would be inapposite to the facts at issue because the IDR in TAM 200142001 related to LIFO inventories and the rationale for finding Statements 1, 2 and 7 to be lacking in specificity was an analogy to the LIFO example. As discussed above, we find analogies to the LIFO example to be unpersuasive in this situation.

3. Sound Tax Administration

Finally, Taxpayer argues that if the sub-method of determining inventoriable costs under § 263A is an issue under consideration by virtue of a request for Taxpayer’s § 263A workpapers, then it would be barred from filing a Form 3115 to change any accounting method for costs subject to § 263A. This, Taxpayer argues, could not have been intended by the drafters of Rev. Proc. 97-27 and would be contrary to sound tax administration and the policy of encouraging voluntary method changes. Our interpretation of IDR General-001 does work to deny Taxpayer the opportunity to file a Form 3115 to change any accounting method used in capitalizing costs to inventory under § 263A, but this result is perfectly consonant with the requirements in Rev. Proc. 97-27 and the Service’s long standing policy on voluntary method changes.

The procedures of Rev. Proc. 97-27 are designed to encourage prompt compliance with proper tax accounting principles and to discourage taxpayers from delaying the filing of applications for accounting method changes, by providing more favorable terms and conditions if the taxpayer voluntarily requests consent to change an accounting method. However, it is well established "that the Commissioner has a legitimate interest in limiting the ability of taxpayers under examination to change improper accounting methods where such restriction is necessary to prevent circumvention or frustration of the examination process." Capitol Federal Savings & Loan Association v. Commissioner, 96 T.C. 204, 220 (1991). For example, PLR 200142001 explains that ”…allowing taxpayers to voluntarily change methods of accounting after they have had an opportunity to peruse the examination plan would encourage taxpayers to wait until they were notified of the contents of the examination plan before requesting accounting method changes.

To encourage voluntary changes, and to discourage the use of the "audit lottery," once the taxpayer is placed under examination, the voluntary consent procedures and their favorable terms and conditions are, generally, no longer available, since the taxpayer's attempt to change is no longer truly voluntary. See, generally, Rev. Proc. 97-27, § 6.01; Rev. Proc. 2002-9, § 4.02(1). However, Rev. Proc. 97-27 does provide limited circumstances in which a taxpayer that is under examination can change a method of accounting under the more favorable terms and conditions. In the instant case, Taxpayer seeks to file Form 3115 under one of the limited circumstances, the 90-day window provided in section 6.01(2). A Form 3115 may be filed within the 90-day window to change a method of accounting under the more favorable terms and conditions unless the method of accounting the taxpayer is requesting to change is, at the time the form is filed, an issue that the examining agent has placed under consideration or has placed in suspense under the written notification and specificity requirements established in section 3.08(1). The requirements in section 3.08(1) seek to ensure that the taxpayer is aware of which accounting method(s) the taxpayer is permitted and not permitted to change during a window period. To this end, the notification must fairly inform the taxpayer of the accounting method(s) or sub-method(s) that will be examined and, therefore, are placed under consideration.

We believe that a reasonable reading of the request for Taxpayer's § 263A workpapers in IDR-General 001 fairly informs Taxpayer that the treatment of costs under § 263A was a matter to be examined and that a reasonable reader would be made aware that the accounting methods or sub-methods used for capitalizing costs under § 263A would be within the scope of the examination and, therefore, would be placed under consideration. To require the level of specificity proposed by Taxpayer and allow a voluntary change in the accounting methods or sub-methods used for capitalizing costs under § 263A after the issuance of a request for a taxpayer's § 263A workpapers would both frustrate the purpose of encouraging voluntary accounting method changes and enable taxpayers to nullify the work of the examining agents.

CONCLUSION

Based on the facts in this case, we find that Taxpayer's method of accounting for capitalizing costs to inventory under § 263A, including both determining inventoriable costs under § 263A and allocating inventoriable costs to items of inventory produced under § 263A, was subject to examination and was an issue under consideration. Further, because royalty costs are costs that may be required to be capitalized to inventory under § 263A, we find that Taxpayer's method of accounting for royalty costs was an issue under consideration within the meaning of section 3.08(1) of Rev. Proc. 97-27, when Taxpayer filed the Form 3115 to request consent to change its method of accounting for royalty costs as of Date 1.

Because we find that IDR General-001 is, in itself, sufficient notification that the accounting method used by Taxpayer to account for royalty costs was an issue under

consideration at the time Taxpayer filed the Form 3115, we need not, and do not, address whether the e-mail of Date 8 constitutes written notification under section 3.08(1) of Rev. Proc. 97-27. In addition, the request for technical advice submitted also asked whether Taxpayer's method of accounting for royalty expense was an issue placed in suspense, within the meaning of Rev. Proc. 97-27, when Taxpayer filed Form 3115 to change its method of accounting for royalty expense on Date 1. Because the request for the year-end 263(A) workpapers in IDR-General 001 placed Taxpayer's method of accounting for royalty expense under consideration, we need not, and do not, address that question.

CAVEAT(S):

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

Please call if you have further questions.

END OF DOCUMENT