

**Office of Chief Counsel
Internal Revenue Service
memorandum**

CC:LM:HMT:DET:
POSTF-125520-04

Number: **20043103F**
Release Date: 7/30/04

UILC: 263A.04-00, 472.08-00

date: June 09, 2004

to: Katheryn N. Titus, Team Manager
(Retail, Food, Pharmaceuticals and Health Care, Team 1603)

from: Area Counsel, LMSB Area 2 (Heavy Manufacturing & Transportation)

subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Date 1 =
Year 1 =
Year 2 =

ISSUE

Whether the permissible variation of the simplified resale method, set forth in Treas. Reg. § 1.263A-3(d)(3)(iii)(B), requires annual increases to the total cumulative amounts of storage and handling costs capitalized to existing LIFO layers.

CONCLUSION

We conclude the variation of the simplified resale method set forth in § 1.263A-3(d)(3)(iii)(B) requires annual increases to cumulative amounts of storage and handling costs capitalized to existing LIFO Layers.

FACTS

Taxpayer filed an Application for Change in Accounting Method (Form 3115) requesting permission to change its method of allocating costs under § 263A of the Internal Revenue Code and the Income Tax Regulations thereunder, for the 52-53-week taxable

year beginning Date 1 (year of change). Taxpayer and the Service executed a consent agreement that provides, in pertinent part --

Taxpayer will use a permissible variation of the simplified resale method without the historic absorption ratio election to allocate additional § 263A costs to ending LIFO inventory. Under this method, Taxpayer will multiply the storage and handling costs absorption ratio by the total § 471 costs included in Taxpayer's ending inventory (rather than just the increment, if any, experienced by Taxpayer during the taxable year) for purposes of determining capitalizable storage and handling costs. See §§ 1.263-3(d)(i) and (iii)(B).

Taxpayer interpreted § 1.263A-3(d)(3)(iii)(B) as permitting an annual substitution of its current storage and handling § 263A rate for its prior storage and handling § 263A rate. The current rate would be multiplied by the LIFO value of the ending inventory to determine the total amount of storage and handling cost to be capitalized to ending inventory. The storage and handling costs capitalized to the beginning inventory for any given year was included in that year's cost of goods sold.

For example, assume Taxpayer had the following LIFO ending inventory at end of Year 2:

YEAR	BASE COST	INDEX	LIFO VALUE
1	\$1,000	1.000	\$1,000
2	<u>\$ 500</u>	1.100	<u>\$ 550</u>
	\$1,500		\$1,550

Assume further the § 263A absorption rate for storage and handling was 2% in Year 1 and 1.5% in Year 2. At the end of Year 1, Taxpayer capitalized \$20.00 ($\$1000 \times 2.0\%$) of storage and handling costs incurred to the ending inventory. In Year 2, Taxpayer included the \$20.00 of storage and handling costs from beginning inventory in cost of goods sold and capitalized \$23.25 ($\$1550 \times 1.5\%$) of storage and handling costs incurred in Year 2 to the ending inventory.

LAW AND ANALYSIS

Treas. Reg. § 1.263A-3(d)(1) provides a simplified resale method for determining the additional § 263A costs properly allocable to property acquired for resale and other eligible property on hand at the end of the taxable year.

Treas. Reg. § 1.263A-3(d)(3)(i)(D)(1) provides under the simplified resale method, the storage and handling absorption ratio is determined by dividing current year's storage and handling costs by beginning inventory plus current year's purchases. Section 1.263A-3(d)(3)(i)(D)(2) defines current year's storage and handling costs as the total storage costs plus the total handling costs incurred during the taxable year that relate to

the taxpayer's property acquired for resale and other eligible property. Beginning inventory in the denominator of the storage and handling costs absorption ratio refers to the section 471 costs of any property acquired for resale or other eligible property held by the taxpayer as of the beginning of the taxable year. Current year's purchases generally mean the taxpayer's section 471 costs incurred with respect to purchases of property acquired for resale during the current taxable year.

Treas. Reg. § 1.263A-3(d)(3)(iii) sets forth the following permissible variations of the simplified resale method:

(A) The exclusion of beginning inventories from the denominator in the storage and handling costs absorption ratio formula in paragraph (d)(3)(i)(D) of this section; or

(B) Multiplication of the storage and handling costs absorption ratio in paragraph (d)(3)(i)(D) of this section by the total § 471 costs included in a LIFO taxpayer's ending inventory (rather than just the increment, if any, experienced by the LIFO taxpayer during the taxable year) for purposes of determining capitalizable storage and handling costs.

Treas. Reg. § 1.263A-3(d)(3)(i)(C) defines the term "section 471 costs remaining on hand at year end" as section 471 costs defined in § 1.263A-1(d)(2) that the taxpayer incurs during the current taxable year, which remain in its ending inventory or are otherwise on hand at year end. For LIFO inventories of a taxpayer, the section 471 costs remaining on hand at year end means the increment, if any, for the current year stated in terms of section 471 costs.

Treas. Reg. § 1.263A-1(d)(2)(i) generally defines section 471 costs, for taxpayers in existence at the time of enactment of section 263A, as costs (other than interest), capitalized under its method of accounting immediately prior to the effective date of section 263A. Thus, although section 471 applies only to inventories, section 471 costs include any non-inventory costs (other than interest) capitalized or included in acquisition or production costs under the taxpayer's method of accounting immediately prior to the effective date of section 263A.

Under the simplified resale method, a taxpayer using the LIFO method multiplies the combined absorption ratio by the current-year cost of the LIFO increment for the current year, if any, to determine the amount of additional § 263A costs incurred during the taxable year that are allocable to ending inventory. See § 1.263A-1(d). The combined absorption ratio is the sum of the purchasing costs absorption ratio and the storage and handling cost absorption ratio. See § 1.263A-1(d)(3)(C)(1). In this case, Taxpayer specifically requested permission to change its method of capitalizing storage and handling costs to the variation permitted under § 1.263A-3(d)(3)(iii)(B). This variation requires Taxpayer to multiply the total § 471 costs included in its ending inventory by the storage and handling costs absorption ratio. This is a departure from the general rule set forth in § 1.263A-3(d)(3)(i)(C) defining section 471 costs on hand at the end of

the year as the LIFO increment, if any, for the current year stated in terms of section 471 costs. Although not specified in § 1.263A-3(d)(3)(iii)(B), the purchasing costs allocable to ending inventory are determined by multiplying the purchasing costs absorption ratio by the LIFO increment for the year, if any. The theory underlying this variation to the simplified resale method is that under the LIFO assumption, beginning inventory is stored year after year and should continue to attract storage and handling costs; but such inventory is not purchased again and therefore should not continue attracting purchasing costs.

The correct application of Treas. Regs. § 1.263A-3(d)(3)(iii)(B) for existing LIFO layers requires the LIFO taxpayer to absorb additional storage and handling costs to these layers. In other words, this method determines the increase in additional section 263A costs from the prior year, not the total additional section 263A storage and handling costs. Section 1.263A-3(d)(3)(iii)(B) does not permit a substitution of rates. Instead it requires storage and handling costs to accumulate for existing LIFO layers. In the above example, the storage and handling costs incurred during Year 2 allocable to the Year 2 layer would be \$8.25 ($\$550 \times 1.5\%$) and the storage and handling costs incurred during Year 2 allocable to the base layer would be \$15.00 ($\$1,000 \times .5\%$). Thus, the total storage and handling costs in ending inventory would be \$43.25 ($\$23.25 (\$8.25 + \$15.00)$ incurred in Year 2 + \$20.00 incurred in Year 1).

In summary, the permissible variation under § 1.263A-3(d)(3)(iii)(B) requires that each LIFO layer continue to absorb storage and handling costs as long as the inventory remains (under a LIFO cost flow assumption) on hand. So a base layer created twelve years prior to Year 2 would accumulate twelve years of storage and handling costs if it still existed in Year 2¹.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Section 11.01, Rev. Proc. 97-27, 1997-1 C.B. 680, provides (in pertinent part) the director of field operations will ascertain if the amount of the § 481(a) adjustment was properly determined and whether the change in method of accounting was implemented as proposed in accordance with the terms and conditions of the consent agreement and Rev. Proc. 97-27. Section 11.02, Rev. Proc. 97-27 provides if the director of field operations recommends that the ruling (other than the amount of the § 481(a) adjustment) should be modified or revoked, the director will forward the matter to the national office for consideration before any further action is taken. Such a referral to the

¹ We note the Bureau of National Affairs (BNA) Tax Management Portfolio, is consistent with our conclusion that the storage and handling costs are cumulative for existing LIFO layers.

"...[T]here is a dramatic difference for LIFO taxpayers, because each year the existing layers will absorb additional costs . . . taxpayers seeking to minimize taxable income would select the basic simplified resale method rather than this variation."

Tax Management Portfolios U.S. Income Series 576-2nd : Uniform Capitalization Rules: Inventory; Self-Constructed Assets; Real Estate 15. 576-2nd Tax Mgmt. Portfolio (BNA)

national office will be treated as a request for technical advice, and the provisions of *Rev. Proc. 97-2* (or any successor) will be followed. We believe that the issue in this case goes directly to how the language in the consent agreement is implemented to determine proper amount of the section 481(a) adjustment. Therefore, our inquiry is not required to be treated as a request for technical advice.

We note § 1.263A-3(d)(3)(iii)(B) does not specifically prescribe how to apply the storage and handling absorption ratio to total § 471 costs in ending inventory. Moreover, the regulations do not explicitly state the amount allocated to existing layers is the summation of all prior year storage and handling cost absorption ratios.

JOSEPH F. MASELLI
Area Counsel, LMSB Area 2
(Heavy Manufacturing and Transportation)

By: _____
Phoebe L. Nearing
Associate Area Counsel (LMSB)

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call _____ if you have any further questions.