What's News in Tax
Analysis That Matters from Washington National Tax

Issues Associated with the Adoption of the Final Repair Regulations for LIFO Taxpayers

Taxpayers subject to the uniform capitalization rules that use the last-in, first-out ("LIFO") method of valuing inventories may face uncertainty and obstacles while adopting the final tangible property (or repair) regulations. This article describes how the repair regulations and the LIFO rules interact and considers some hurdles LIFO taxpayers may face.

Monday, May 19, 2014

by Mathew McNeil, John Suttora, Carol Conjura, and Eric Lucas, Washington National Tax

Matthew McNeil is a manager and John Suttora and Carol Conjura are partners and Eric Lucas is a principal in WNT's Income Tax and Accounting group.

On September 13, 2013, Treasury and the IRS issued final regulations addressing the deduction and capitalization of amounts paid to acquire, produce, or improve tangible property under sections 162 and 263(a) (the "final repair regulations"). The final repair regulations, which are effective for tax years beginning on or after January 1, 2014, are complex and require careful consideration of each taxpayer's facts and circumstances. Many taxpayers—particularly those that produce property or acquire property for resale, and as a result, are subject to the uniform capitalization rules under section 263A—are finding the process of implementing and quantifying the impact of changes made under the final repair regulations to be quite a challenge. This can be an especially daunting task for taxpayers using the last-in, first out ("LIFO") method of valuing inventories, as discussed in more detail below.

Interplay between Section 481 Adjustment and Section 263A

In general, accounting method changes under the final repair regulations implicate the provisions of section 446(e) and the regulations thereunder, which require a full section 481(a) adjustment. Transition guidance issued with respect to the final repair regulations generally permit repair method changes to be filed under the automatic consent procedures described in Revenue Procedure 2011-14. The revenue procedure requires taxpayers to compute any required section 481 adjustment taking into account "all relevant accounts."[1] Because repair expenses and depreciation allowances on tangible property used in the production of inventory are often required

[1] Rev. Proc. 2011-14 section 2.05(1).

to be allocated and capitalized to inventory under section 263A, taxpayers are required to account for the impact of section 263A when computing the section 481(a) adjustment related to a change in method of accounting made pursuant to the final repair regulations.

For example, a taxpayer that files a capitalization-to-repair change in 2014 would have to reduce its section 481(a) adjustment (computed as of the beginning of 2014) by the amount of the repair adjustment allocable to inventory under section 263A. This step should not present too much difficulty for taxpayers using the first-in, first-out ("FIFO") cost flow assumption because the adjustment would generally affect the inventory costs under section 263A for the immediately preceding tax year because, in most cases, the inventory turns over within a single year. However, taxpayers using the LIFO cost flow assumption face the additional task of allocating the section 481(a) adjustment for repairs (and depreciation allowances) to prior-period LIFO layers. In that situation, the amount of the benefit that may be expected from a capitalization-to-repair method change may be reduced by the portion of the section 481(a) adjustment allocable to prior-period LIFO layers. However, taxpayers would be permitted to remove any depreciation related to prior period improvements that had been allocated to LIFO layers subsequent to the year in which the improvement was placed in service. Likewise, a similar result will apply to those taxpayers making a concurrent uniform capitalization change to take book-tax differences such as repairs items and depreciation into account.

Section 1.263A-7 provides the framework for revaluing inventories on hand at the beginning of the taxable year in which a change method of accounting for costs subject to section 263A is filed. For LIFO taxpayers, computation of the section 481(a) adjustment will depend on the approach taken to revalue inventories (e.g., facts and circumstances revaluation method or the three-year average method). It may also depend on the method used for allocating such book-tax differences under the uniform capitalization rules.

Facts and Circumstances Revaluation Method

Under a facts and circumstances revaluation method, LIFO taxpayers would recompute each prior-period LIFO layer, taking into account the portion of the additional repairs (as well as any corresponding reduction in

Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

depreciation expense) that would have been incurred in each year that a layer was added.[2] Although the preferred approach would be to trace the additional repairs to specific goods on hand and included in each prior-period LIFO layer, a taxpayer may instead be able to use other reasonable estimates and procedures in revaluing inventory costs if the necessary information to perform a more specific allocation is unavailable.[3]

In the example above, if a taxpayer has the ability to trace the additional repair costs to inventory costs making up the increment of a given year, then only the additional repair costs that relate to the inventory costs remaining in each layer at the beginning of the year of the change would reduce the taxpayer's section 481(a) adjustment. However, if the taxpayer is unable to trace the costs to inventory costs making up the increment of a given year, the taxpayer could look to use other reasonable procedures in revaluing the inventory. One potential approach would involve the computation of a ratio equal to the current value of a given LIFO layer divided by the total purchase and production costs incurred during the applicable year. The taxpayer would apply this ratio to the additional repair (or depreciation) costs for the applicable year to determine the portion of the adjustment that is deemed to remain in the cost of the taxpayer's increment. Such an approach is similar to the increment valuation method used in the consolidated return regulations,[4] as well as the principles established in Revenue Ruling 2001-8 with respect to floor stock taxes.

To illustrate this approach, take for example a taxpayer valuing inventory using LIFO and the latest acquisition cost method of valuing increments. If for a given tax year the taxpayer incurs $20 million of acquisition costs, but the remaining layer for the year is only $1 million, then five percent of any dollar of additional repair costs would be deemed to remain in the cost of that layer. Therefore, ignoring the impact of any offsetting adjustments to depreciation, if additional repair costs of $500,000 were determined to have been incurred during the tax year, then $25,000 (5% x $500,000) of

---

2 Section 1.263A-7(c)(2)(iii).
3 *Id.*
4 Section 1.1502-13(e)(1)(ii)(C).

the additional repair costs would be added to the cost of LIFO layer and the section 481(a) adjustment would be reduced by the same amount.[5]

For taxpayers using the inventory price index computation (“IPIC”) method for determining LIFO carrying values, or one of the simplified methods provided in the uniform capitalization regulations, the approach discussed above would not affect the inflation index computed for each LIFO layer, only the ending LIFO carrying value of inventory. However, taxpayers using a self-developed index and that incorporate uniform capitalization costs to develop that index would need to consider the impact on their inflation index for each appropriate layer. While a facts and circumstances method would provide a more accurate revaluation of inventory, not all taxpayers have the records necessary to perform such a calculation, particularly those with existing layers dating back many years. Taxpayers using the dollar-value LIFO method that are unable to use a facts and circumstances revaluation approach should consider the three-year average method to revalue their LIFO inventory.

Three-Year Average Method

The three-year average method is based on the average percentage change (the three-year valuation factor) 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.[6] The three-year revaluation factor is applied to all layers for each pool in beginning inventory in the year of change. Generally, a taxpayer revaluing its inventory using the three-year average method must establish a new base year. However, a dollar-value LIFO taxpayer using the three-year average method and either the simplified production method or the simplified resale method to revalue its inventory is permitted, but not required, to establish a new base year.

In the initial example above, a taxpayer using the three-year average method would recompute the current-year cost of its ending inventory for the impact of changes in repair costs (and related changes to depreciation) for the three most recent tax years for which the taxpayer has sufficient

5 Ignoring, for simplicity, the timing of the repairs expense and the taxpayer’s method of pricing current year increments (for example, the earliest or latest acquisitions methods).

6 Section 1.263A-7(c)(2)(v).

information. The average percentage of change in inventory costs for the three-tax-year period would then be multiplied by the values associated with each LIFO layer remaining in the opening inventory as of the beginning of the tax year of change. The overall difference in LIFO inventory value would equal the reduction to the section 481(a) adjustment for the capitalization-to-repairs change.

Concurrently Filed Section 263A Method Changes

Taxpayers who are otherwise in compliance with section 263A and need only to account for the effects of a repairs change on their section 481(a) adjustment do not file a separate Form 3115. However, a taxpayer that uses improper section 263A methods for costs that it wants to change under the final repair regulations, for example, or desires to make any other section 263A change, may generally do so concurrently with the repairs change, e.g., a taxpayer that who does not consider book-tax differences in computing the section 263A adjustment should consider filing a concurrent method change under section 263A. One of the important changes in Revenue Procedure 2014-16 is to clarify that a taxpayer's repair change is not conditioned on compliance with section 263A. However, to encourage compliance with section 263A, Revenue Procedure 2014-16 provides liberal procedures for taxpayers to make a concurrent change under section 263A. Most notable is that for concurrently filed changes included on a single Form 3115 for tax years beginning before January 1, 2015, the revenue procedure waives certain scope limitations for the automatic change procedures under Revenue Procedure 2011-14. This waiver allows taxpayers under examination, including those for which section 263A is an item under consideration, to file both changes (section 263A and repairs) under the automatic consent procedures, thereby granting the taxpayer audit protection with respect to both methods. Taxpayers changing their section 263A method would compute the corresponding section 481(a) adjustment by applying the procedures discussed in section 1.263A-7 and outlined above.

Conclusion

Taxpayers that are using the LIFO method of valuing inventories and are planning to file a change in method of accounting under the final repair regulations must consider the impact, if any, that section 263A will have on the computation of the section 481(a) adjustments related to the change and on the tax value of their inventory, in the aggregate and on a layer-by layer-basis. Taxpayers whose section 263A method does not properly account for costs they want to change under the final repair regulations are encouraged to file concurrent method changes for section 263A to comply with the regulations. A scope limitation waiver provided by transition guidance issued with respect to the final repair regulations may provide taxpayers under exam the opportunity to file the concurrent change under the automatic change procedures without regard to whether the section 263A method is an issue under consideration in the examination.

For further information, please contact any of the individuals listed below.

Name	Phone	Email
Eric Lucas	(202) 533-3023	ejlucas@kpmg.com
Carol Conjura	(202) 533-3040	cconjura@kpmg.com
John Suttora	(202) 533-4150	jsuttora@kpmg.com
Matthew Borrack	(813) 301-2283	mborrack@kpmg.com
Mathew McNeil	(202) 533-3376	mmcneil@kpmg.com

KPMG's *What's News in Tax* is a publication from Washington National Tax that contains thoughtful analysis of new developments and practical, relevant discussions of existing rules and recurring tax issues.