

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 446, 471, 472, 481; 1.446-1, 1.471-3(d), 1.472-8, 1.481-1)

Rev. Proc. 2006-14

SECTION 1. PURPOSE

This revenue procedure provides heavy equipment dealers (as defined in section 4.05 of this revenue procedure) with a safe harbor method of accounting for their heavy equipment parts inventory (as defined in section 4.06 of this revenue procedure). This safe harbor method permits heavy equipment dealers to approximate the cost of their heavy equipment parts inventory using the replacement cost of the heavy equipment parts pursuant to the replacement cost method described in section 4 of this revenue procedure. This revenue procedure also provides procedures for heavy equipment dealers to obtain the automatic consent of the Commissioner to change to the replacement cost method.

SECTION 2. BACKGROUND

.01 Section 471 of the Internal Revenue Code provides that inventories must be taken on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

.02 Section 1.471-3(d) of the Income Tax Regulations provides that in any industry in which the usual rules for computation of cost are inapplicable, cost may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry.

.03 Section 472(a) provides that a taxpayer may use the last-in, first-out (LIFO) inventory method. Under the LIFO inventory method, a taxpayer treats those goods remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year. The change to, and use of, the LIFO inventory method must be in accordance with such regulations as the Secretary may prescribe as necessary in order that the use of such method may clearly reflect income.

.04 Section 472(b)(2) provides that a taxpayer using the LIFO inventory method must inventory its goods at cost.

.05 Section 1.472-8(a) provides that a taxpayer may elect to determine the cost of its LIFO inventories under the dollar-value LIFO method, provided such method is used consistently and clearly reflects the income of the taxpayer in accordance with the rules of that section.

.06 Section 1.472-8(e)(2)(ii) provides that the total current-year cost of items making up a dollar-value LIFO pool may be determined: (a) by reference to the actual cost of the goods most recently purchased or produced; (b) by reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition; (c) by application of an average unit cost

equal to the aggregate cost of all the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced; or (d) pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

.07 Section 263A generally requires direct costs and an allocable portion of indirect costs of certain property produced or acquired for resale by a taxpayer to be included in inventory costs, in the case of property that is inventory, or to be capitalized, in the case of other property. Section 1.263A-1(e)(2)(ii) provides that resellers must capitalize the acquisition costs of property acquired for resale. In addition, resellers must capitalize the indirect costs described in § 1.263A-1(e)(3), which are properly allocable to property acquired for resale. These indirect costs often include purchasing, handling, and storage costs. See § 1.263A-3(c)(1).

.08 In Mountain State Ford v. Commissioner, 112 T.C. 58 (1999), the Tax Court held that a taxpayer that sold heavy truck parts and used the dollar-value LIFO method to account for its parts inventory was not entitled to determine the current-year cost of the parts in its ending inventory by reference to their replacement cost. In so doing, the court found that the taxpayer's replacement cost method was not in accordance with the method elected on its Form 970, Application to Use LIFO Inventory Method. The taxpayer's Form 970 indicated that it would determine the current-year cost of the items in its ending inventory by reference to the actual cost of the goods most recently purchased or produced in accordance with § 1.472-8(e)(2)(ii)(a). The court further concluded that even if

the taxpayer had elected to use another proper method under § 1.472-8(e)(2)(ii)(d), it could not use the replacement cost of the parts to determine current-year cost because replacement cost does not determine current-year cost on the basis of, or by reference to, actual cost (or in some instances a reasonable approximation of actual cost) in accordance with § 472(b).

.09 Subsequent to the Mountain State Ford decision, the Internal Revenue Service gave careful consideration to the following unique circumstances surrounding the use of replacement cost by automobile dealers:

(1) *Industry practice.* It has been the long-standing and widespread practice of automobile dealers to use replacement cost to determine the cost of their vehicle parts inventory both for financial accounting and federal income tax purposes.

(2) *Use of replacement cost required by third party.* Automobile dealers are commonly required by their franchisors (i.e., the vehicle's manufacturer) to value their vehicle parts inventory using replacement cost, rather than actual cost.

(3) *Substantial burden associated with switching to actual cost.* The automobile dealer industry has represented that automobile dealers that are presently using replacement cost to value their vehicle parts inventory likely would incur substantial expense if they were required to modify their existing record keeping systems to determine the cost of such inventory using actual cost.

(4) *Replacement cost approximates actual cost in this industry.* The automobile dealer industry has provided data to demonstrate that, on average, in their industry, due to relatively low inflation and high inventory turnover, the replacement cost of vehicle parts approximates the actual cost of such parts.

.10 Consideration of these factors led the Service to conclude that, for reasons of administrative convenience, burden reduction, and avoidance of further controversy in this area, a safe harbor method of accounting to determine the cost of vehicle parts inventory using replacement cost to approximate actual cost should be provided to automobile dealers. Accordingly, automobile dealers were provided a safe harbor method of accounting in Rev. Proc. 2002-17, 2002-1 C.B. 676. The Service stated in Rev. Proc. 2002-17 that it was willing to consider requests of other industries for similar safe harbors if the facts of those industries are similar to those described above.

.11 Subsequent to the publication of Rev. Proc. 2002-17, the heavy equipment dealer industry asked the Service to provide a similar safe harbor that would allow heavy equipment dealers to value their heavy equipment parts inventories at replacement cost. The information submitted on behalf of the heavy equipment dealers has led the Service to conclude that the circumstances in the heavy equipment dealer industry are similar to those described in section 2.09 of this revenue procedure. Accordingly, the Service has concluded, for reasons of administrative convenience and burden reduction, that a safe harbor method of accounting to determine the cost of heavy equipment parts inventory, using replacement cost to approximate actual cost, should be provided to heavy

equipment dealers. The safe harbor method is provided in section 4 of this revenue procedure and is available to heavy equipment dealers described in section 4.05 of this revenue procedure.

SECTION 3. SCOPE

This revenue procedure applies to any heavy equipment dealer that is engaged in the trade or business of selling heavy equipment parts at retail and that is authorized under an agreement with one or more heavy equipment manufacturers or distributors to sell new heavy equipment.

SECTION 4. REPLACEMENT COST METHOD

.01 *In General.* A taxpayer that is within the scope of this revenue procedure is permitted to use the replacement cost method to approximate the actual cost of its heavy equipment parts inventory. Under the replacement cost method, a taxpayer must determine the cost of the heavy equipment parts in its inventory by reference to the replacement cost of the heavy equipment parts as defined in section 4.02 of this revenue procedure, determine the replacement cost using a standard price list as defined in section 4.03 of this revenue procedure, and satisfy the book conformity requirement as described in section 4.04 of this revenue procedure. Taxpayers within the scope of this revenue procedure may use the replacement cost method in conjunction with either the first-in, first-out inventory method or the LIFO inventory method. Taxpayers that use the replacement cost method provided by this section 4 and that are subject to the provisions of § 263A must include in inventory costs the additional amounts that are required by §§ 1.263A-1 and 1.263A-3 (e.g., freight costs).

.02 Replacement Cost. Replacement cost means the amount provided in a standard price list at which a heavy equipment part may be purchased by the taxpayer on the date of the inventory. If, on the date of the inventory, the heavy equipment part is not provided in a standard price list, the replacement cost for the part is equal to the last amount provided in a standard price list (i.e., the price at which the part was last offered for purchase in a standard price list).

.03 Use of Standard Price List. A "standard price list" is a price list that is widely recognized and used for business purposes in the heavy equipment dealer industry and that is used by the taxpayer in the ordinary course of its business to purchase the heavy equipment parts for which it is determining the cost.

.04 Book Conformity. A taxpayer satisfies the book conformity requirement if it determines the cost of heavy equipment parts in its inventory using the replacement cost of the heavy equipment parts as defined in section 4.02 when it ascertains the income, profit, or loss of its trade or business for purposes of its books, records, and reports (including financial statements) to its shareholders, partners, other proprietors, beneficiaries, and creditors.

.05 Heavy Equipment Dealer Defined. For purposes of this revenue procedure, a taxpayer is a "heavy equipment dealer" only if it sells new heavy equipment under an agreement with one or more heavy equipment manufacturers or distributors and earns a majority of its revenue from the sale, or sale and lease, of new heavy equipment. Heavy equipment is defined as those

items that fall within the Bureau of Labor Statistics Producer Price Indices WPU111 and WPU112.

.06 Heavy Equipment Parts Inventory. For purposes of this revenue procedure, “heavy equipment parts inventory” means goods held as inventory that are, or could be, used to replace original parts on heavy equipment, are necessary for the proper operation of that heavy equipment, and are not accessories.

.07 Future Reconsideration of the Use of Replacement Cost. If the Service later determines that circumstances have changed so that the replacement cost of heavy equipment parts no longer approximates the actual cost of heavy equipment parts, the Service may reconsider the safe harbor replacement cost method provided in this section 4 of this revenue procedure and may modify or revoke the method for future taxable years.

SECTION 5. AUDIT PROTECTION FOR TAXPAYERS CURRENTLY USING THE REPLACEMENT COST METHOD

A taxpayer within the scope of this revenue procedure that is using the replacement cost method provided in section 4 of this revenue procedure on January 4, 2006, may continue to use this safe harbor method for taxable years ending on or after April 30, 2005, without filing a Form 3115, Application for Change in Accounting Method. Such taxpayer's method of using replacement cost to determine cost for its heavy equipment parts inventory will not be raised as an issue by the Service in a taxable year that ends before April 30, 2005. Moreover, if such taxpayer's method of using replacement cost to determine cost for its heavy equipment parts inventory is already an issue under consideration in

a taxable year that ends before April 30, 2005, the issue will not be further pursued by the Service.

SECTION 6. CHANGE IN METHOD OF ACCOUNTING

.01 *In General.* A change to the replacement cost method provided by this revenue procedure is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. Therefore, a taxpayer within the scope of this revenue procedure that does not use the replacement cost method provided in section 4 of this revenue procedure on January 4, 2006, but wants to use this safe harbor method may do so for a taxable year ending on or after April 30, 2005, and must file a Form 3115.

.02 *Automatic change to the replacement cost method.* A taxpayer within the scope of this revenue procedure that wants to change its method of determining cost to the replacement cost method provided by this revenue procedure must follow the automatic change in accounting method provisions of Rev. Proc. 2002-9, 2002-1 C.B. 327, as 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, with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to a taxpayer that wants to make the change for its first or second taxable year ending on or after April 30, 2005;

(2) A change to the replacement cost method under the provisions of Rev. Proc. 2002-9 must be effected on a cut-off method. Thus, the change in method of accounting is made without a § 481(a) adjustment;

(3) A taxpayer making a change under this section 6.02 of this revenue procedure for its first taxable year ending on or after April 30, 2005, that before February 3, 2006, filed its original federal income tax return for such year is not required to comply with the filing requirement in section 6.02(3)(a) of Rev. Proc. 2002-9, provided the taxpayer complies with the following filing requirement. The taxpayer must complete and file a Form 3115 in duplicate. The original must be attached to an amended federal income tax return for the taxpayer's first taxable year ending on or after April 30, 2005. This amended return must be filed no later than July 3, 2006. A copy of the Form 3115 must be filed with the national office (see section 6.02(6) of Rev. Proc. 2002-9) no later than when the taxpayer's amended return is filed; and

(4) For purposes of Line 1a of Form 3115, the designated number for the automatic accounting method change authorized by this revenue procedure is "96." A taxpayer making the automatic change in method of accounting authorized by this revenue procedure and another automatic change in method of accounting under § 263A for the same taxable year may file one Form 3115 to make both changes, but must comply with the ordering rules of § 1.263A-7(b)(2), and must enter the automatic accounting method change numbers for both changes on Line 1a of Form 3115.

.03 Audit Protection. If a taxpayer complies with the requirements of this revenue procedure and changes its method of determining cost for its heavy equipment parts inventory to the replacement cost method provided in section 4 of this revenue procedure, the taxpayer will receive audit protection for any taxable year before the year of change with respect to the taxpayer's method of determining cost for its heavy equipment parts inventory under § 471 or 472. See section 7 of Rev. Proc. 2002-9. However, if this change in method of accounting is made for the taxpayer's first or second taxable year ending on or after April 30, 2005, and the taxpayer's method of determining cost (other than by use of replacement cost) for its heavy equipment parts inventory under § 471 or 472 is an issue under consideration as of January 4, 2006, in a taxable year that ends before April 30, 2005, the taxpayer will not receive audit protection.

SECTION 7. RECORD KEEPING

Section 6001 provides that every person liable for any tax imposed by the Code, or for the collection thereof, must keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. The books or records required by § 6001 must be kept at all times available for inspection by authorized internal revenue officers or employees, and must be retained so long as the contents thereof may become material in the administration of any internal revenue law. Section 1.6001-1(e). In order to satisfy the record keeping requirements of § 6001 and the regulations thereunder, a taxpayer that uses the replacement cost method should maintain records supporting all aspects of its inventory

valuation including, but not limited to, the price list described in section 4 of this revenue procedure.

SECTION 8. MODIFICATION OF REV. PROC. 2002-17

Rev. Proc. 2002-17 is amended by adding the following new section 4.05: *Future Reconsideration of the Use of Replacement Cost*. If the Service later determines that circumstances have changed so that the replacement cost of vehicle parts no longer approximates the actual cost of vehicle parts, the Service may reconsider the safe harbor replacement cost method provided in this section 4 of this revenue procedure and may modify or revoke the method for future taxable years.

SECTION 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-9 is modified and amplified to include this automatic change in section 10.02 of the APPENDIX.

Rev. Proc. 2002-17 is modified.

SECTION 10. EFFECTIVE DATE

This revenue procedure generally is effective for taxable years ending on or after April 30, 2005.

DRAFTING INFORMATION

The principal author of this revenue procedure is Richard Shevak of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Mr. Shevak at (202) 622-4930 (not a toll-free number).