Part I

Section 471.--General Rule for Inventories

26 CFR 1.471-3: Inventories at Cost.
(Also '' 61; 111; 472; 1.472-2.)

Rev. Rul. 2001-8

ISSUE

What is the proper method of accounting for payments made or received with respect to “floor stocks”?

BACKGROUND

A floor stocks provision, which applies to a designated type of goods held in inventory (floor stocks) on a particular date (the “floor stocks date”), is sometimes enacted in conjunction with a tax, change in tax rate, or subsidy that is imposed upon similar goods purchased or produced on or after that date. The purpose of a floor stocks provision is to ensure that all goods sold on or after the floor stocks date are subjected to the same total amount of tax or subsidy, regardless of whether the items sold were goods held as floor stocks on the floor stocks date or goods purchased or produced after that date. This equal treatment is achieved by imposing with respect to goods held on the floor stocks date an amount, to be either paid or received, that will serve to eliminate any differential in total tax or subsidy that would otherwise exist relative to goods subsequently purchased or produced.

The Internal Revenue Service, in two previous revenue rulings, has addressed the proper tax treatment of payments received with respect to floor stocks. Rev. Rul.

88-95, 1988-2 C.B. 28, and Rev. Rul. 85-30, 1985-1 C.B. 20, generally provide that payments received with respect to floor stocks should be treated as either an item of gross income or a reduction in inventory, depending on whether the cost of the goods to which the payments relate remains in ending inventory under the taxpayer's cost flow assumption. However, questions continue to arise about how the "goods to which the payments relate" should be determined, particularly when the last-in, first-out (LIFO) inventory method is used.

The purpose of this revenue ruling is to clarify that payments made or received with respect to floor stocks must be accounted for as adjustments to the invoice price or production cost of the goods physically held on the floor stocks date to which the payments relate, rather than as an adjustment to the tax basis (carrying value) of those goods. This revenue ruling also provides, for costing purposes, an optional simplifying assumption for LIFO taxpayers regarding identification of the goods physically held on the floor stocks date to which the floor stocks payments relate.

LAW

Section 471(a) 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.

Section 1.471-3 of the Income Tax Regulations provides rules for determining the cost of merchandise on hand at the beginning of the taxable year and the cost of merchandise purchased or produced since the beginning of the taxable year.

Section 472(a) provides that taxpayers may use the LIFO method of inventorying goods in accordance with such regulations as the Secretary may prescribe as necessary in order that the use of such method may clearly reflect income.

Section 472(b) and sec.1.472-1 require taxpayers using the LIFO inventory method to treat 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 and to the extent thereof; and second, those acquired during the taxable year. Section 472(b) and sec. 1.472-2 require taxpayers using the LIFO method to inventory their goods at cost.

Section 263A(a) provides, in the case of property that is inventory in the hands of the taxpayer, that the direct costs and an allocable share of the indirect costs (including taxes) of the property must be included in inventory costs.

Section 1.263A-1(e)(3)(i) 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-2(a)(3)(iii) provides that producers must capitalize all indirect costs incurred subsequent to completion of production that are properly allocable to the property produced.

Section 61(a) provides generally that gross income means all income from whatever source derived.

Rev. Rul. 85-30 addresses the income tax treatment of payments received by a retail dealer of highway vehicle tires as a reimbursement of federal excise taxes previously paid with respect to floor stocks of certain tires held on the floor stocks date. Rev. Rul. 85-30 holds that the excise tax reimbursement should be treated as a reduction in ending inventory to the extent that it relates to tires the cost of which remains in ending inventory. Rev. Rul. 85-30 further holds that the excise tax reimbursement should be treated as an item of gross income to the extent that it relates to tires the cost of which does not remain in ending inventory and has been included in cost of goods sold.

Rev. Rul. 88-95 addresses the income tax treatment of two types of payments received by a textile manufacturer that were attributable to domestically produced raw cotton that was either held as of a specific date (*i.e.*, floor stocks) or purchased subsequent to that date. Rev. Rul. 88-95 holds that both types of payments should be treated as a reduction in the inventory cost of the cotton giving rise to the payments to the extent that the cost is deemed to remain in inventory at the date the payments are accrued under the taxpayer's method of accounting. Rev. Rul. 88-95 further holds that the payments should be treated as an item of gross income to the extent that the cost of the cotton giving rise to the payments is deemed to have been relieved from inventory and accounted for through cost of goods sold as of the date the payments are accrued under the taxpayer's method of accounting.

Mohawk Liqueur Corp. v. United States, 324 F.2d 241 (6th Cir. 1963), *cert. denied,* 377 U.S. 905 (1964), addressed the specific question of whether the taxpayer, a manufacturer of alcoholic beverages, could deduct floor stocks taxes on distilled spirits instead of including them in inventory in accordance with its previous practice.

The court held that consistency in inventory practice is required. As a result, the taxpayer was not allowed to deviate from its prior practice of including floor stocks taxes in inventory.

Turtle Wax, Inc. v. Commissioner, 43 T.C. 460 (1965), held that refunds of federal excise taxes on watches were taxable income to the extent that the taxpayer had derived a tax benefit related to the payment of such taxes from deductions taken in prior years.

ANALYSIS

The inventory accounting rules generally require a taxpayer to first determine the cost of goods purchased or produced during a taxable year and then to allocate that cost between goods sold during that taxable year and goods that remain in ending inventory based on the taxpayer's inventory cost flow assumption. *See* sec. 1.471-3 and 1.263A-1(c)(1).

Payments made with respect to floor stocks (*e.g.*, taxes) represent an inventoriable cost of the goods to which the payments relate under sec. 471 and 263A. *See* sec. 263A(a). Similarly, payments received with respect to floor stocks (*e.g.*, tax refunds or subsidy payments) represent a reduction in the purchase price or production cost of the goods giving rise to the payments. *See* Rev. Rul. 85-30; Rev. Rul. 88-95.

Thus, consistent with the requirements of sec. 1.471-3 and 1.263A-1, payments made or received with respect to floor stocks must be accounted for as adjustments to the cost of the goods physically held on the floor stocks date to which the payments relate. "Cost" for this purpose means invoice price or production cost. The resultant effect on either gross income or inventory depends on the extent to which the cost of the goods physically held on the floor stocks date remains in ending inventory. Whether the cost of the goods physically held on the floor stocks date remains in ending inventory is determined by applying the taxpayer's inventory cost flow assumption (*e.g.*, LIFO, first-in, first-out (FIFO), or a specific-goods method) to identify the particular costs that are deemed to be contained in ending inventory. *See* Rev. Rul. 85-30; Rev. Rul. 88-95.

Therefore, to the extent that the cost of the goods associated with the floor stocks payments has been included in cost of goods sold under the taxpayer's inventory cost flow assumption, payments made (or received) with respect to floor stocks increase (or decrease) cost of goods sold. However, payments received that relate to goods the cost of which has been included in cost of goods sold in a previous year under the taxpayer's inventory cost flow assumption increase gross income, consistent with operation of the tax benefit rule as illustrated in *Turtle Wax*, 43 T.C. at 466). For taxpayers using a LIFO inventory method, this treatment ensures that payments made or received with respect to floor stocks do not affect historical LIFO cost increments that contain the cost of unrelated goods.

Similarly, to the extent that the cost of the goods associated with the floor stocks payments remains in ending inventory under the taxpayer's inventory cost flow assumption, payments made (or received) with respect to floor stocks increase (or decrease) ending inventory. For taxpayers using a LIFO inventory method, payments made or received with respect to floor stocks affect ending inventory only when one or more LIFO cost increments that remain in ending inventory, as computed under ' 472(b) and sec. 1.472-1, include the cost of the goods physically held on the floor stocks date. For taxpayers using a FIFO inventory method, payments made or received with respect to floor stocks generally are included in cost of goods sold and not ending inventory because the goods physically held on the floor stocks date to which the payments relate usually do not remain in FIFO inventory at the end of the year.

Mohawk Liqueur was decided on grounds of consistency in inventory practice and did not address the issue considered in this revenue ruling, *i.e.,* the proper method of accounting for floor stocks taxes under a particular inventory cost flow assumption.

EXAMPLES

The following four examples illustrate the proper income tax accounting treatment of payments made and received with respect to floor stocks:

Example 1. *X* files returns on a calendar year basis using an accrual method of accounting and the double-extension, dollar-value LIFO method of inventorying goods. *X* has only one item, Product 1, in its dollar-value LIFO pool. The federal excise tax on Product 1 decreases on January 1, 2000, from 104 to 84 per unit. Simultaneously, a floor stocks provision is implemented that entitles merchants holding Product 1 in inventory on January 1, 2000, upon which an excise tax of 104 per unit had previously been paid, to a refund of 24 per unit. *X* held 10,000 units of Product 1 on January 1, 2000, and received an associated $200 excise tax refund in 2000. The 10,000 units of Product 1 that *X* physically held on January 1, 2000, were purchased in 1999. *X*=s December 31, 1999, LIFO inventory consists of a 1995 LIFO cost increment that includes the cost of 3,000 units of Product 1 and a 1999 LIFO cost increment that contains the cost associated with an additional 7,000 units. These 1995 and 1999 increments remain in *X*=s 2000 LIFO ending inventory.

X must account for the $200 excise tax refund in 2000 as follows: The $200 refund represents a reduction in the invoice price of the 10,000 units of Product 1 purchased in 1999 and held on January 1, 2000. Of these 10,000 units, only the cost of 7,000 units remains in *X*'s 2000 ending inventory under *X*'s LIFO inventory cost flow assumption as part of a 1999 increment; thus, $140 of the $200 refund (7,000/10,000 x $200 = $140) is allocated to these units, resulting in a $140 decrease in 2000 ending inventory. ($140 must be subtracted from the current-year cost of the 1999 LIFO cost increment and the index (*i.e.*, the ratio of total current-year cost to total base-year cost) for the 1999 increment would be recalculated). The cost of the remaining 3,000 of these 10,000 units was included in cost of goods sold in 1999 under *X*'s LIFO inventory cost flow assumption. Thus, $60 of the refund (3,000/10,000 x $200 = $60) must be included in gross income in 2000.

Example 2. *Y* files returns on a calendar year basis using an accrual method of accounting and the double-extension, dollar-value LIFO method of inventorying goods. A floor stocks provision is implemented on July 1, 2000, that entitles merchants holding Product 2 in inventory on that date to receive inventory protection (subsidy) payments of $1 per unit. *Y* held 50,000 units of Product 2 on July 1, 2000, and received an associated $50,000 inventory protection payment in 2000. The 50,000 units of Product 2 that *Y* physically held on July 1, 2000, were purchased in 2000. The cost of these units does not remain in *Y'*s 2000 LIFO ending inventory, which consists of 1996, 1997, and 1998 LIFO cost increments.

Y must include the entire $50,000 inventory protection payment as a decrease in 2000 cost of goods sold because the cost of the associated goods was included in 2000 cost of goods sold and thus does not remain in 2000 ending inventory under *Y*=s LIFO inventory cost flow assumption.

Example 3. Z files returns on a calendar year basis using an accrual method of accounting and the double-extension, dollar-value LIFO method of inventorying goods. *Z* has only one item, Product 3, in its dollar-value LIFO pool. The federal excise tax on Product 3 increases on January 1, 2000, from 64 to 104 per unit. Simultaneously, a floor stocks tax provision is implemented that requires producers holding Product 3 in inventory on January 1, 2000, upon which an excise tax of 64 per unit had previously been paid, to pay an additional excise tax of 44 per unit. *Z* has 100,000 units of Product 3 on hand on January 1, 2000, and pays the additional excise tax of $4,000 in 2000. The 100,000 units of Product 3 that *Z* physically held on January 1, 2000, were produced in 1999 and subjected to a 64 per unit excise tax in 1999. *Z'*s December 31, 1999, LIFO inventory consists of LIFO cost increments from 1990, 1993, and 1996. The cost of these 100,000 units does not remain in *Z'*s 2000 LIFO ending inventory because *Z* did not add a LIFO cost increment in 1999.

Z must include the entire $4,000 floor stocks tax in cost of goods sold in 2000 because the production cost of the associated goods was included in cost of goods sold in 1999 and thus does not remain in 2000 ending inventory under *Z'*s LIFO inventory cost flow assumption.

Example 4. The facts are the same as *Example 3*, except that the cost of 60,000 of the 100,000 units of Product 3 that *Z* produced in 1999 and physically held on January 1, 2000, is included in a 1999 LIFO cost increment. The cost of these 60,000 units remains in *Z*'s 2000 LIFO ending inventory because *Z* did not have an inventory decrement in 2000.

Z must account for the $4,000 floor stocks tax in 2000 as follows: $2,400 must be assigned as an increase in the production cost of the 60,000 units held on January 1, 2000, that were produced in 1999 the cost of which remains in 2000 ending inventory under *Z*'s LIFO inventory cost flow assumption as part of a 1999 LIFO cost increment (60,000/100,000 x $4,000 = $2,400). This adjustment results in an increase in 2000 ending inventory ($2,400 must be added to the current-year cost of the 1999 LIFO cost increment and the index (*i.e.*, the ratio of total current-year cost to total base-year cost) for the 1999 increment would be recalculated). The remaining $1,600 of the floor stocks tax must be included in cost of goods sold in 2000 because the production cost of the 40,000 units of Product 3 produced in 1999 with which it is associated was included in 1999 cost of goods sold and thus does not remain in 2000 ending inventory under *Z*=s LIFO inventory cost flow assumption.

HOLDING

Payments made or received with respect to floor stocks must be accounted for as adjustments to the invoice price or production cost of the goods physically held on the floor stocks date to which the payments relate. Payments made or received with respect to floor stocks affect inventory valuation only to the extent that the invoice price or production cost of the goods on hand that gave rise to the payments has not been included in cost of goods sold but remains in ending inventory under the taxpayer=s inventory cost flow assumption. Payments made or received with respect to floor stocks affect gross income to the extent that the invoice price or production cost of the goods on hand that gave rise to the payments has been included in cost of goods sold and thus is not included in ending inventory under the taxpayer’s inventory cost flow assumption.

SIMPLIFYING ASSUMPTION REGARDING GOODS ON HAND

Identification of the goods that were physically held on the floor stocks date may be unduly burdensome for some taxpayers, particularly LIFO taxpayers with large inventories of fungible goods. As a matter of administrative convenience, the Service will permit LIFO taxpayers to assume that the goods physically held on the floor stocks date are those most recently purchased or produced. This simplifying assumption for payments made or received with respect to floor stocks is a method of accounting that must be applied on a consistent basis and used only for the purpose of identifying the goods physically held on the floor stocks date for costing purposes.

PROSPECTIVE APPLICATION

Pursuant to the authority contained in sec. 7805(b) of the Code, the conclusions in this revenue ruling will not be applied adversely to challenge a consistent treatment by taxpayers of payments made or received with respect to floor stocks on or before February 26, 2001.

CHANGE IN METHOD OF ACCOUNTING

A change to comply with this revenue ruling is a change in method of accounting to which the provisions of sec. 446 and the regulations thereunder apply. A taxpayer wanting to change its method of accounting to conform with the holding in this revenue ruling or to elect the simplifying assumption must follow the automatic change in accounting method provisions of Rev. Proc. 99-49, 1999-52 I.R.B. 725 (or its successor), provided the change is made for the first taxable year in which payments are made or received with respect to floor stocks subsequent to February 26, 2001, with the following modifications: (1) the scope limitations in section 4.02 of Rev. Proc. 99-49 do not apply (if the taxpayer is under examination, before an appeals office, or before a federal court with respect to any income tax issue, the taxpayer must provide a copy of the Form 3115, Application for Change in Accounting Method, to the examining agent, appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the Form 3115 with the national office); (2) in lieu of the label required by section 6.02(3) of Rev. Proc. 99-49, a taxpayer should write "Filed pursuant to Rev. Rul. 2001-8" at the top of its Form 3115; (3) any change in method of accounting to comply with the holding in this revenue ruling is to be made using a cut-off method relative to payments made or received with respect to floor stocks on or before February 26, 2001 (*see* section 2.06 of Rev. Proc. 99-49); (4) a taxpayer should clearly indicate on its Form 3115 or in an attachment thereto if it is electing to use the simplifying assumption to identify the goods physically held on the floor stocks date for costing purposes.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 85-30 is clarified to reflect that the reimbursement of excise taxes is treated as a reduction in the invoice price of the tires physically held on the floor stocks date.

Rev. Rul. 88-95 is clarified to reflect that the inventory protection payments are treated as a reduction in the invoice price of the cotton physically held on the floor stocks date. Rev. Proc. 99-49 is modified and amplified to include this automatic change in section 9 of the APPENDIX.

DRAFTING INFORMATION

The principal author of this revenue ruling is Alan J. Tomsic of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Tomsic on (202) 622-4970 (not a toll-free call).