Notice of Proposed Rulemaking and Notice of Public Hearing

Dollar-Value LIFO Regulations; Inventory Price Index Computation Method

REG–107644–98

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 472 of the Internal Revenue Code that relate to accounting for inventories under the last-in, first-out (LIFO) method. The proposed regulations provide guidance regarding methods of valuing dollar-value LIFO pools and affect persons who elect to use the dollar-value LIFO and inventory price index computation (IPIC) methods. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by August 17, 2000. Requests to speak (with outlines of oral comments) at a public hearing scheduled for September 15, 2000 at 10 a.m., must be received by August 25, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–107644–98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–107644–98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/tax_regs/regslist.html. The public hearing will be held in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jeffery G. Mitchell, (202)622-4970; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor of the Regulations Unit at (202) 622-7180 (not toll-free calls).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) that relate to the last-in, first-out (LIFO) inventory accounting method under section 472 of the Internal Revenue Code (Code). The LIFO method of accounting for goods treats inventories on hand at the end of the year as consisting first of inventory on hand at the beginning of the year and then of inventories acquired during the year.

Under §1.472–8, a taxpayer is permitted to use the dollar-value LIFO method of accounting for inventories, which accounts for inventories in terms of dollars of cost rather than specific goods. The dollar-value LIFO method measures increases or decreases in inventory quantities by comparing the total cost of the quantity of goods on hand at the beginning and end of the taxable year in terms of equivalent-value dollars, i.e., base-year cost. The current-year dollar cost of beginning and ending inventory may be converted into a base-year dollar cost using price indexes. Then, the quantity of base-year cost in beginning and ending inventory can be compared and the increase (increment) or decrease (liquidation) can be measured.

Section 472(f) directs the Secretary to prescribe regulations that permit the use of suitable published governmental price indexes for purposes of the LIFO method. The IRS and Treasury Department prescribed the inventory price index computation (IPIC) method in §1.472–8(e)(3) (TD 7814, 47 FR 11271, 1982–1 C.B. 84), pursuant to authority contained in sections 472 and 7805. Under the IPIC method, inventory price indexes are computed with reference to consumer or producer price indexes published by the United States Bureau of Labor Statistics (BLS). The IPIC method was intended to simplify the use of the dollar-value LIFO method so that the LIFO method could be used by more taxpayers and would be easier to use by taxpayers already using the dollar-value LIFO method.

Explanation of Provisions

This document contains proposed amendments to the IPIC method provided in §1.472–8(e)(3) of computing the LIFO value of a dollar-value inventory pool that are intended to simplify and clarify certain aspects of the IPIC method as well as to modify the computational methodology so that the IPIC method produces a more accurate and suitable inventory price index. In addition, the proposed regulations provide rules for computing the LIFO value of a dollar-value pool when a taxpayer receives LIFO inventories in certain nonrecognition transactions.

1. *Elimination of Requirement to Use 10 Percent Categories and BLS Weights*

Section 1.472–8(e)(3)(iii) of the regulations provides detailed rules for assigning inventory items to index categories published by the BLS in the "CPI Detailed Report" or the "PPI Detailed Report" for purposes of computing an inventory price index. Items are first assigned to the most detailed index category listed in the appropriate table of the "CPI Detailed Report" or the "PPI Detailed Report" that contains those items. If the total current-year cost of the items in a single detailed index category equals or exceeds 10 percent of the total inventory value, the taxpayer must use the published index for that selected index category for all items that are included in that detailed index category. If the total current-year cost of items in a single detailed index category is less than 10 percent of the total inventory value, the taxpayer must investigate successively less detailed index categories until it reaches an index category that meets the 10 percent threshold. The taxpayer, however, may only use the published index for a less detailed selected index category if it has at least one item that would have been included in each of the most detailed index

categories subsumed by the selected category. For example, a taxpayer may only use the published index for the "Fresh fruits" category from the "CPI Detailed Report" if its inventory includes at least one apple, banana, orange, citrus fruit other than orange, and other fresh fruit. If the taxpayer's inventory does not contain at least one item in each of the most detailed index categories within the selected index category, the taxpayer must compute an appropriate index for the selected index category. An appropriate index for the selected index category is a weighted average of the published indexes for the most detailed index categories that include at least one of the taxpayer's inventory items. The weights to be used in computing the appropriate index are the BLS weights listed for the detailed index categories. In computing an index for a pool, however, a taxpayer must weight the appropriate indexes for the selected index categories comprising the pool according to the taxpayer's actual inventory weights for those selected index categories.

The proposed regulations eliminate the requirement to use 10 percent categories and BLS weights to determine an appropriate index for two reasons. First, the weight assigned to an index category by the BLS may vary dramatically from the taxpayer's actual inventory weight for that category. Consequently, the index computed for those items using BLS weights will not accurately reflect the taxpayer's inflation experience. Second, the requirement to use 10 percent categories and BLS weights was intended to simplify the index computation procedure for those taxpayers that did not keep detailed inventory records. In practice, however, this requirement adds complexity to the index computation for most taxpayers. Moreover, even the most detailed BLS index categories are fairly broad and, with current inventory recordkeeping procedures and practices, most taxpayers have sufficiently detailed books and records to classify their inventory items according to the most detailed BLS index categories.

The proposed regulations require a taxpayer to classify its inventory items into the most detailed index category listed in the "CPI Detailed Report" or the "PPI Detailed Report." For purposes of computing a weighted average pool index, the weight assigned to each selected index category will be the relative current-year cost of the items in that category. The IRS and Treasury Department request written comments regarding rules for excluding index categories that contain items with a de minimis amount of relative current-year cost from the pool index computation.

2. *Weighted Harmonic Mean for Computing Pool Index*

A pool index computed using the dollar-value LIFO method should reflect a weighted average of the inflation rates of the items contained in the ending inventory. Under LIFO methods that compute an internal index, the index computation procedure automatically produces an appropriately weighted pool index. However, when a taxpayer computes a LIFO inventory pool index using externally generated inflation rates, the taxpayer must weight the inflation rates to compute an appropriate composite index for the pool.

Section 1.472–8(e)(3)(iii)(B) states that the appropriate indexes are weighted according to the relative current-year costs of the items in each selected index category. However, the regulations do not set forth how to compute a weighted average of the appropriate indexes using the amount of relative current-year costs in each selected index category. The IRS provided an example of IPIC weighting methodology in Rev. Proc. 84–57 (1984–2 C.B. 496). The example computes a weighted average pool index based on a weighted arithmetic mean of the appropriate indexes. (Weighted Arithmetic Mean = [Sum of (Weight x Appropriate Index)] / Sum of Weights). The example provided in Rev. Proc. 98–49 (1998–37 I.R.B. 9), also used a weighted arithmetic mean to compute a weighted average percent change for a selected index category.

The IRS and Treasury Department have determined that a weighted arithmetic mean is mathematically inappropriate for averaging inflation indexes based on current-year costs. The mathematically correct method of averaging inflation indexes using relative current-year costs is a weighted harmonic mean. (Weighted Harmonic Mean = Sum of Weights / Sum of [Weight / Appropriate Index]). Therefore, the proposed regulations make the weighted harmonic mean the only acceptable method of computing a weighted average pool index using relative current-year costs of items in ending inventory.

3. *Double-extension or Link-Chain Method of Index Computation*

The current regulations do not indicate whether the inventory price index should be computed using a link-chain or double-extension methodology. Section 1.472–8(e)(3)(ii) merely states that "[a]n inventory price index computed [under the IPIC method] shall be a stated percentage of the percent change in the selected consumer or producer price index or indexes for a specific category or categories of goods."

In practice, some taxpayers have used a link-chain methodology, and others a double-extension methodology. The proposed regulations specifically permit either method. The proposed regulations also explain how to compute an index under each method and provide examples.

4. *Selecting Indexes as of an Appropriate Month*

Section 1.472–8(e)(3)(iii)(C) states that a taxpayer not using the retail inventory method must select indexes "as of the month or months" most appropriate to its method of determining current-year cost, or make a one-time binding election of an appropriate representative month. The IRS has ruled that a month is an appropriate representative month if there is a nexus between the selected month, the taxpayer's method of determining current-year cost, and the taxpayers' historical experience of inventory purchases. Rev. Rul. 89–29 (1989–1 C.B. 168). In practice, there has been confusion about the meaning of the phrase "month or months most appropriate to the taxpayer's method of determining current-year cost."

The proposed regulations clarify that, for each dollar-value pool, a taxpayer should either annually determine the month most appropriate to its method of determining the current-year cost of the pool (appropriate month) or make a one-time election of a representative appropriate month (representative month) for the pool. The principles of Rev. Rul. 89–29 continue to apply for purposes of determining whether a particular month is appropriate or representative. An appropri-

ate index is computed by comparing the published cumulative index for the appropriate or representative month to the published cumulative index for the appropriate or representative month used for the immediately preceding year (in the case of a taxpayer using the link-chain IPIC method) or the published cumulative index for the month preceding the first day of the base year (in the case of a taxpayer using the double-extension IPIC method). The proposed regulations also clarify that a taxpayer electing to use a representative month must use an appropriate month, rather than the representative month, to compute an appropriate index in certain circumstances, such as a short taxable year.

5. *Taxpayers Eligible to Use "Department Store Inventory Price Indexes"*

The current regulations prohibit the use of the IPIC method by a taxpayer that is eligible to use inventory price indexes prepared by the BLS for the purpose of valuing the LIFO inventories of a specific industry. Specifically, §1.472–8(e)(3)(i) provides that a taxpayer eligible to use the retail price indexes prepared by the BLS and published in "Department Store Inventory Price Indexes" may not use the IPIC method.

Some retailers may carry goods traditionally carried by department stores and other goods that are not traditionally carried by department stores. Such taxpayers may qualify as department stores, but "Department Store Inventory Price Indexes" may not provide indexes that are applicable for some of the taxpayers' departments. Whenever one or more departments of a department store do not fit into any one of the 23 major groups established by the BLS or into the special combinations listed in Rev. Proc. 86–46 (1986–2 C.B. 739), the taxpayer may use either an index that represents an average for the whole of the remainder of the LIFO inventory or the store total index published by the BLS. However, the express terms of the current regulations prohibit taxpayers eligible to value their LIFO inventories using "Department Store Inventory Price Indexes" from using the IPIC method to compute an index for any dollar-value pool.

The proposed regulations eliminate the eligibility restrictions applicable to the IPIC method. Generally, any taxpayer may adopt the IPIC method as long as it uses that method for all goods accounted for under the dollar-value LIFO method. However, a taxpayer eligible to use "Department Store Inventory Price Indexes" may elect to use those indexes for LIFO inventory items that fall within any of the 23 major groups listed in "Department Store Inventory Price Indexes" and the IPIC method for the remainder of its LIFO inventory items, or may elect to use the IPIC method for all of its LIFO inventories. The proposed regulations do not, however, affect the ability of an eligible taxpayer to use "Department Store Inventory Price Indexes" to value its LIFO inventories in accordance with §1.472–1(k) and Rev. Proc. 86–46.

6. *Selection from "CPI Detailed Report" or "PPI Detailed Report"*

Section 1.472–8(e)(3)(iii)(C) states that a retailer may select indexes from the "CPI Detailed Report" or the "PPI Detailed Report," but if equally appropriate indexes may be selected from either, a retailer using the retail inventory method must select from the "CPI Detailed Report" and a retailer not using the retail inventory method must select from the "PPI Detailed Report."

The proposed regulations eliminate the need for a retailer to determine whether the "CPI Detailed Report" and "PPI Detailed Report" contain equally appropriate indexes. The proposed regulations require retailers using the retail inventory method to select indexes from the "CPI Detailed Report." All other taxpayers must select indexes from the "PPI Detailed Report."

7. *Elimination of Requirement to Convert Published Indexes into Retail Price Indexes or Cost Price Indexes*

Section 1.472–8(e)(3)(iii)(C) provides that if a retailer using the retail inventory method selects an index from the "PPI Detailed Report," the selected index must be converted into a retail price index, and that if a retailer not using the retail inventory method selects an index from the "CPI Detailed Report," the selected index must be converted into a cost price index. The regulations further provide that manufacturers, processors, wholesalers, jobbers, and distributors must convert selected indexes into cost price indexes.

This conversion requirement in the current regulations was intended to more accurately represent the taxpayer's inflation experience relative to the selected price index. However, due to the inability of many taxpayers to determine gross profit percentages at the detailed index category level and the fact that gross profit percentages for many taxpayers are relatively constant, this conversion requirement may not actually increase the accuracy of the indexes used in the inventory price index computation. The IRS and Treasury Department have concluded that the administrative burden of converting published indexes into retail price or cost price indexes outweighs any benefits of increased accuracy from the procedure. Thus, the proposed regulations eliminate the requirement to convert published price indexes into either retail price indexes or cost price indexes.

8. *Relocation and Clarification of Special Pooling Rules*

Section 1.472–8(e)(3)(iv) provides special, elective pooling rules for retailers, wholesalers, jobbers, and distributors that use the IPIC method. Such taxpayers are permitted to establish an inventory pool for any group of goods included in one of the eleven general categories of consumer goods described in the "CPI Detailed Report." Although wholesalers, jobbers and distributors are allowed to pool goods according to categories found in the "CPI Detailed Report," they must select indexes from the "PPI Detailed Report" pursuant to §1.472–8(e)(3)(iii)(C). The current regulations provide no special, elective pooling rules for manufacturers that use the IPIC method. However, Rev. Proc. 84–57 provides that an inventory pool or pools may be established for any group of goods included within one of the 15 general categories of producer goods described in Table 6 of the "PPI Detailed Report."

The proposed regulations provide special, elective pooling rules for LIFO inventories accounted for under the IPIC method. Specifically, retailers using the retail inventory method may establish an inventory pool for any group of goods accounted for under the IPIC method included within one of the general expenditure categories (i.e., major groups) in

Table 3 of the "CPI Detailed Report." Retailers not using the retail method, wholesalers, jobbers, distributors, processors, and manufacturers may establish an inventory pool for any group of goods accounted for under the IPIC method included within one of the 2-digit commodity codes (i.e., major commodity groups) in Table 6 of the "PPI Detailed Report." The special, elective pooling rules provided in the proposed regulations correspond with the pooling rules found in section 474(b) so that a taxpayer may change from the simplified dollar-value LIFO method of section 474 to the IPIC method without changing its pooling structure. In addition, the special, elective pooling rules for taxpayers using the IPIC method are relocated with the general pooling rules applicable to all taxpayers in §1.472–8(b) and (c).

9. *Clarification of the Definition of "Eligible Small Business"*

Section 1.472–8(e)(3)(ii) permits an eligible small business, as defined under section 474(b) of the Internal Revenue Code of 1954, to compute an inventory price index for its pool(s) using 100 percent of the percent change in the selected indexes. All other taxpayers must compute an inventory price index for their pools using 80 percent of the percent change in the selected indexes. At the time the regulations were published, section 474(b) defined an eligible small business as a taxpayer with average annual gross receipts that did not exceed $2,000,000 for the 3-taxable-year period ending with the taxable year.

Section 474 was amended by the Tax Reform Act of 1986. Public Law 99-514, 100 Stat. 2348. An eligible small business is now defined by section 474(c) as a taxpayer with average annual gross receipts that do not exceed $5,000,000 for the 3 preceding taxable years. The proposed regulations clarify that the IPIC method definition of "eligible small business" mirrors the definition in current section 474.

10. *New Base Year for IPIC Method Changes*

Section 1.472–8(e)(vi) requires a taxpayer that changes to the IPIC method from another dollar-value LIFO method to treat the year of change as the base year in determining the LIFO value of the inventory pool(s) for the year of change and later taxable years. The taxpayer is also required to restate indexes of existing layers of increment in terms of new base-year cost. This procedure is generally known as updating the base year.

The proposed regulations clarify that the base year updating procedure applies in the case of a voluntary change to the IPIC method, but is discretionary in the case of an involuntary change to the IPIC method. If an examining agent determines that a taxpayer's dollar-value LIFO method does not clearly reflect income, the agent may require the taxpayer to change to the double-extension IPIC method on a cut-off basis with or without an updated base year. If the examining agent chooses not to update the base year, the examining agent will ascertain the amount of any increment in terms of base-year cost for the year of change by comparing the total base-year cost of the beginning inventory determined under the taxpayer's dollar-value LIFO method and the total base-year cost of the ending inventory determined under the double-extension IPIC method. Any increment so determined will be valued using the index computed under the double-extension IPIC method.

11. *Inventories Received in a Nonrecognition Transaction*

Under current law, the treatment of LIFO inventories received in a nonrecognition transaction depends upon whether the transaction qualifies as a corporate reorganization to which section 381 applies. Section 381(c)(5) provides that inventory accounting methods generally carry over, uninterrupted, to a transferee in a transaction described in section 381(a).

However, inventory accounting methods generally do not carry over to a transferee in other nonrecognition transactions such as transfers to a controlled corporation under section 351, divisive "D" reorganizations under section 368(a)(1)(D), or contributions to a partnership under section 721 (non-section 381 transfers). *Textile Apron Company, Inc. v. Commissioner*, 21 T.C. 146 (1953), *acq.*, 1954–1 C.B. 7. But see §1.263A–7(c)(4); 1.1502–17. If a transferee that has never owned inventories or that has accounted for inventories using a method other than LIFO wants to use the LIFO method to account for inventories received in a non-section 381 transfer, it must elect the LIFO method for the year of transfer. The inventories received in the transfer are treated as opening inventory and their cost is determined using the average cost method as provided in section 472(b)(3). Rev. Rul. 70–564 (1970–2 C.B. 109). A transferee that previously elected to use the LIFO method may account for the LIFO inventories received in a non-section 381 transfer using its preexisting LIFO method. The LIFO layers of the transferor retain the transferor's original acquisition dates and costs and are integrated into the transferee's existing LIFO layers. *Commissioner v. Joseph E. Seagram & Sons, Inc.*, 394 F.2d 738 (1968), rev'g, 46 T.C. 698 (1966); Rev. Rul. 70–565 (1970–2 C.B. 110).

An election to use the dollar-value LIFO method for LIFO inventories received in a non-section 381 transfer, however, may not continue the LIFO reserve of the transferor. If the mix of goods in the inventory changes significantly after the transfer, the mechanics of the dollar-value LIFO method may produce an increment in the first taxable year that effectively eliminates the LIFO reserve established by the transferor. This occurs because the transferee's base year is the year in which it elects LIFO.

A taxpayer using the dollar-value LIFO method determines whether there is an increase or decrease in the quantity of inventory by comparing the base-year cost of the ending inventory to the base-year cost of the beginning inventory. When inventory is received in a non-section 381 transfer, the transferee's basis is determined by reference to the transferor's basis in the inventory. The transferee's base-year cost, however, is not determined by reference to the transferor's base-year cost. The transferee's base-year cost of inventory received in a non-section 381 transfer is equal to the transferee's cost of the inventory, which is generally the carryover basis of the inventory. Since the transferor's basis was established by reference to the actual cost of the goods in years prior to the transfer, the carryover basis of the inventory may be considerably lower than what it would cost to purchase or produce the goods in the current year. If a new item enters the

transferee's inventory, §1.472–8(e)(2)(iii) only permits the transferee to reconstruct the base-year unit cost of that item back to the year in which it elected LIFO. If the transferee elected LIFO in the year in which the non-section 381 transfer occurred, the base-year unit cost of the new item will not be comparable to the base-year unit cost of the items that were received in the transfer and comprised the opening inventory. The disparity in the base-year unit costs may produce an increment in terms of base-year cost that would not have occurred but for the low base-year unit cost of the inventory received in the transfer.

While the current regulations contain a provision requiring a taxpayer that changes to the IPIC method from another LIFO method to treat the year of change as the base year in determining the LIFO value of the inventory pool(s) for the year of change and later taxable years, the provision does not apply to an initial adoption of LIFO by a transferee. When a transferee elects the LIFO and IPIC methods for LIFO inventories received in a non-section 381 transfer, the transferee will have an increment in the year in which the inventories are received even without a significant change in the mix of goods in the transferee's ending inventory. The IPIC method invariably produces an increment because the index used to convert the current-year cost of the ending inventory to base-year cost will reflect only one year of inflation while the difference between the current-year cost and the carryover basis of the opening inventory reflects more than one year of inflation.

The IRS and Treasury Department have determined that recapture of the LIFO reserve established by the transferor's use of the dollar-value LIFO method solely by virtue of the mechanical application of the dollar-value LIFO method after a non-section 381 transfer is inappropriate, given the business continuity principles governing the tax treatment of the underlying transaction. Accordingly, the proposed regulations provide that if a transferee uses the dollar-value LIFO method for inventories that were received in a nonrecognition transaction to which section 381 does not apply and that were accounted for using the dollar-value LIFO method by the transferor, the transferee must use the year of transfer as the base year and the transferor's current-year cost of the inventory received as the new base-year cost of such inventory for purposes of determining future increments and liquidations. The proposed regulations do not affect a newly formed transferee's ability to elect new accounting methods or the holdings of Rev. Rul. 70–564 and Rev. Rul. 70–565. However, the new base year rule does not apply to a non-section 381 transaction if the transaction was made with the principal purpose of availing the transferee of a method of accounting that would be unavailable to the transferor (or would be unavailable without securing consent from the Commissioner). In determining the principal purpose of a transfer, consideration will be given to all of the facts and circumstances. However, if a transferor acquired inventory in a bargain purchase within the five taxable years preceding the year of the transfer and accounted for that inventory using a dollar-value LIFO method that did not treat the bargain purchase inventory and physically identical inventory acquired at market prices as separate items, the transfer will be deemed made with the principal purpose of availing the transferee of a method of accounting that would be unavailable to the transferor (or would be unavailable without securing consent from the Commissioner).

Proposed Effective Date

These regulations are proposed to be effective for taxable years beginning on or after the date they are published in the **Federal Register** as final regulations.

Effect on Other Documents

Rev. Proc. 84–57 will become obsolete as of the date these regulations are published in the **Federal Register** as final regulations. In addition, Rev. Proc. 98–49 is modified with respect to the requirements to use 10 percent categories and BLS weights, to compute a weighted average using a weighted arithmetic mean, and to convert selected indexes to cost, as of the date these regulations are published in the **Federal Register** as final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) and electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 15, 2000, at 10 a.m., in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written or electronic comments by August 17, 2000, and submit an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by August 25, 2000.

A period of 10 minutes will be allocated to each person for making com-

ments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Jeffery G. Mitchell of the Office of Assistant Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§1.472–8 also issued under 26 U.S.C. 472. * * *

Par. 2. Section 1.472–8 is amended as follows:

1. Paragraph (b)(4) is added.

2. The text of paragraph (c) following the paragraph heading is redesignated as paragraph (c)(1) and a paragraph heading for newly designated (c)(1) is added.

3. Paragraph (c)(2) is added.

4. Paragraphs (e)(3) and (h) are revised.

The revisions and additions read as follows:

§1.472–8 Dollar-value method of pricing LIFO inventories.

* * * * *

(b) * * *

(4) *Inventory price index pools.* A manufacturer or processor that elects to use the inventory price index computation method described in paragraph (e)(3) of this section to value its dollar-value pools may establish an inventory pool for any group of goods included within one of the 2-digit commodity codes (i.e., major commodity groups) in Table 6 (Producer price indexes for commodity groups, subgroups, product classes, and individual items) of the "PPI Detailed Report" published by the United States Bureau of Labor Statistics (available from New Orders, Superintendent of Documents, P.O. Box 371954, Pittsburgh, PA 15250–7954). Inventory pools that comprise less than 5 percent of the total inventory value may be combined to form a single miscellaneous inventory pool. If the resulting miscellaneous inventory pool itself comprises less than 5 percent of the total inventory value, that pool may be combined only with the largest inventory pool.

(c) * * *(1) *In general.* * * *

(2) *Inventory price index pools.* A retailer using the retail inventory method that elects to use the inventory price index computation method described in paragraph (e)(3) of this section (the IPIC method) may establish an inventory pool for any group of goods accounted for under the IPIC method included within one of the general expenditure categories (i.e., major groups) in Table 3 (Consumer Price Index for all Urban Consumers (CPI-U): U.S. city average, detailed expenditure categories) of the "CPI Detailed Report" published by the United States Bureau of Labor Statistics (available from New Orders, Superintendent of Documents, P.O. Box 371954, Pittsburgh, PA 15250-7954). A retailer not using the retail inventory method, wholesaler, jobber, or distributor electing to use the IPIC method may establish an inventory pool for any group of goods accounted for under the IPIC method included within one of the 2-digit commodity codes (i.e., major commodity groups) in Table 6 (Producer price indexes for commodity groups, subgroups, product classes, and individual items) of the "PPI Detailed Report" published by the United States Bureau of Labor Statistics. Inventory pools that comprise less than 5 percent of the total inventory value may be combined to form a single miscellaneous inventory pool. If the resulting miscellaneous inventory pool itself comprises less than 5 percent of the total inventory value, that pool may be combined only with the largest inventory pool.

* * * * *

(e) * * *

(3) *Inventory price index computation method*—(i) *In general.* The inventory price index computation method provided by this paragraph (e)(3) (the IPIC method) is a method of determining the LIFO value of a dollar-value inventory pool with reference to indexes published by the United States Bureau of Labor Statistics (BLS). An inventory price index computed using the IPIC method will be accepted by the Commissioner as an appropriate method of computing an index, and the use of that inventory price index to compute the LIFO value of a dollar-value inventory pool will be accepted as accurate, reliable, and suitable. The appropriateness of a taxpayer's computation of an inventory price index, including the selection of the consumer or producer price indexes and the propriety of all computations incidental to the use of those consumer or producer price indexes, will be determined in connection with the examination of the taxpayer's income tax return. A taxpayer using the IPIC method may elect to establish inventory pools in accordance with the special rules in paragraphs (b)(4) and (c)(2) of this section or the general rules for establishing inventory pools in paragraphs (b) and (c) of this section. Taxpayers eligible to use the IPIC method are described in paragraph (e)(3)(ii) of this section. The manner in which an inventory price index is computed using the IPIC method is described in paragraph (e)(3)(iii) of this section. Rules relating to the adoption of, or change to, the IPIC method are in paragraph (e)(3)(iv) of this section.

(ii) *Eligibility.* Any taxpayer electing to use the dollar- value LIFO method may elect to compute an inventory price index in accordance with the IPIC method. Except as provided in this paragraph (e)(3)(ii), a taxpayer using the IPIC method must use that method in determining the value of all goods for which the taxpayer has elected to use the dollar-value LIFO method. A taxpayer that uses the retail price indexes prepared by the BLS and published in "Department Store Inventory Price Indexes" (available from the BLS by calling (202)606-6325 and entering document code 2415) may elect to use the IPIC method for inventory items that do not fall within any of the major groups listed in "Department Store Inventory Price Indexes."

(iii) *Computation of an inventory price index*—(A) *In general.* An inventory price index computed using the IPIC method is used to convert the current-year cost of the inventory in a dollar-value inventory pool to base-year cost for purposes of determining whether an incre-

ment or liquidation in terms of base-year cost exists and to value the increment, if any, at current-year cost. A taxpayer must compute a separate inventory price index for each dollar-value inventory pool. The computation of an index for each pool involves the following four steps which are described in more detail in this paragraph (e)(3)(iii): first, selection of a BLS table and an appropriate month, second, selection of an index category, third computation of an appropriate index for each selected index category, and fourth, computation of a pool index. A taxpayer may compute an inventory price index for each dollar-value inventory pool under the IPIC method using a double-extension method (the double-extension IPIC method) or a link-chain method (the link-chain IPIC method) without regard to whether the use of a double-extension method is impractical or unsuitable. See paragraphs (e)(3)(iii)(D) and (E) of this section. The use of the double-extension IPIC method or the link-chain IPIC method is a method of accounting, and whichever method is adopted must be applied consistently to all of the taxpayer's dollar-value inventory pools accounted for using the IPIC method.

(B) *Selection of a BLS table and appropriate month—*(*1*) *In general.* An inventory price index computed using the IPIC method is computed with reference to the consumer or producer price indexes for specific categories of inventory items listed in the "CPI Detailed Report" or "PPI Detailed Report" published by the BLS for the appropriate month. A taxpayer may elect to use either the preliminary or final indexes published by the BLS for the appropriate month provided that the chosen indexes are used consistently from year to year. A taxpayer that elects to use final indexes must use preliminary indexes for the appropriate month for any taxable year in which it files its original federal income tax return before the BLS publishes final indexes.

(*2*) *BLS table selection.* Manufacturers, processors, wholesalers, jobbers, distributors, and retailers not using the retail inventory method must select indexes from Table 6 (Producer price indexes for commodity groups, subgroups, product classes, and individual items) of the "PPI Detailed Report," unless the taxpayer can demonstrate that the selection of an index from another table of the "PPI Detailed Report" would be more appropriate. Retailers using the retail inventory method must select indexes from Table 3 (Consumer Price Index for all Urban Consumers (CPI-U): U.S. city average, detailed expenditure categories) of the "CPI Detailed Report."

(*3*) *Appropriate month.* In the case of a retailer using the retail inventory method, the appropriate month is the last month of the retailer's taxable year. In the case of all other taxpayers, the appropriate month is a month most appropriate to the taxpayer's method of determining the current-year cost of each dollar-value inventory pool under paragraph (e)(2)(ii) of this section. A taxpayer not using the retail inventory method may annually select an appropriate month for each dollar-value inventory pool or make an election of a representative appropriate month (representative month). An election of a representative month is a method of accounting and must be used for the taxable year of the election and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner as provided in §1.446-1(e) to change or revoke its election. The election of a representative month must be clearly set forth on Form 970. See paragraph (e)(3)(iv)(A) of this section.

(C) *Selection of an index category—*(*1*) *In general.* The inventory items in each dollar-value pool should be classified according to the most detailed listings in the appropriate tables of the "CPI Detailed Report" or the "PPI Detailed Report." The selection of a consumer or producer price index category for a specific item to compute an inventory price index under the IPIC method is a method of accounting. However, the selection of a new consumer or producer price index category for a specific item as a result of revisions to the "CPI Detailed Report" or the "PPI Detailed Report" is a change in underlying facts and not a change in method of accounting. Change in method of accounting rules relating to changes in selected indexes are in paragraph (e)(3)(iv) of this section.

(*2*) *Index selection from the PPI Detailed Report.* Manufacturers, processors, wholesalers, jobbers, distributors, and retailers not using the retail inventory method must classify their inventory items according to the detailed listings in the appropriate table(s) of the "PPI Detailed Report." Each specific inventory item in the taxpayer's inventory must be assigned to the most detailed index category listed in the appropriate tables (as determined under paragraph (e)(3)(iii)(B)(*2*) of this section) of the "PPI Detailed Report" that includes that specific inventory item. Manufacturers and processors must assign each raw material inventory item to the most detailed index category that includes that raw material and each finished good inventory item to the most detailed index category that includes that finished good. Manufacturers and processors must assign work-in-process inventory items to the most detailed index category that includes the finished good into which the item will be manufactured or processed. For this purpose, the term finished good means a good that is in a saleable state. For example, a gasoline engine manufacturer that also produces pistons for the engines must assign finished pistons that have not yet been affixed to an engine block and the piston work-in-process items to the most detailed index category that includes pistons. Finished pistons that have been affixed to an engine block must be assigned to the most detailed index category that includes the engine.

(*3*) *Index selection from the CPI Detailed Report.* Retailers using the retail inventory method must classify their inventory items according to the detailed listings in the appropriate tables of the "CPI Detailed Report." Each specific inventory item in the taxpayer's inventory must be placed in the most detailed index category listed in the appropriate table (as determined under paragraph (e)(3)(iii)(B)(*2*) of this section) of the "CPI Detailed Report" that includes that specific inventory item.

(D) *Computation of an appropriate index—*(*1*) *Double- extension IPIC method.* In the case of a taxpayer using the double-extension IPIC method, an appropriate index for a selected index category is the percent change in the published cumulative indexes for that category for the index period between the appropriate or representative month of the current taxable year (determined under paragraph (e)(3)(iii)(B)(*3*) of this section) and the month preceding the first day of

the base year (the base month). The percent change in the published indexes is equal to the quotient of the published cumulative index for the appropriate or representative month of the current year divided by the published cumulative index for the base month.

(*2*) *Link-chain IPIC method*. In the case of a taxpayer using the link-chain IPIC method, an appropriate index for a selected index category is the percent change in the published cumulative indexes for that category during the index period between the appropriate or representative month of the current taxable year (determined under paragraph (e)(3)(iii)(B)(3) of this section) and the appropriate or representative month used for the immediately preceding taxable year. The percent change in the published indexes is equal to the quotient of the published cumulative index for the appropriate or representative month of the current year divided by the published cumulative index for the appropriate or representative month used for the immediately preceding year (or, for the month immediately preceding the first day of the taxable year, if such year is the first taxable year in which the taxpayer uses dollar-value LIFO).

(*3*) *Limitation on index period.* A taxpayer electing to use a representative month under paragraph (e)(3)(iii)(B)(*3*) of this section must use an appropriate month, rather than the representative month, to determine the index period in the circumstances described in this paragraph (e)(3)(iii)(D)(*3*) and other similar circumstances. For example, if the first taxable year in which the taxpayer uses the IPIC method is also the first taxable year in which the taxpayer uses the dollar-value LIFO method, the index period is the period between the month immediately preceding the first day of the taxable year and an appropriate month for that taxable year. Likewise, in the case of a short taxable year, the index period ordinarily is the period between the base month (double-extension IPIC method) or the appropriate or representative month used for the preceding taxable year (link-chain IPIC method) and the appropriate month for the short taxable year. Similarly, if a taxpayer using the link-chain IPIC method is granted consent to change its method of determining the current-year cost of a dollar-value pool and its representative month, the index period is the period between the old representative month used for the preceding taxable year and the new representative month for the year of change.

(E) *Computation of a pool index*—(*1*) *Weighted average pool index*. To compute an inventory price index for a dollar-value pool, a taxpayer must compute a weighted average pool index. A weighted average pool index is a weighted harmonic mean of the appropriate indexes (determined under paragraph (e)(3)(iii)(D) of this section) for each selected index category represented in the taxpayer's ending inventory. The formula for computing a weighted harmonic mean is: Sum of weights / Sum of (Weight / Appropriate Index). The costs to be used in computing a weighted harmonic mean are the relative amount of current-year costs (or, in the case of a retailer using the retail inventory method, the relative retail selling prices) in each index category represented in the ending inventory of the pool.

(*2*) *Double-extension IPIC method*. Under the double- extension IPIC method, an inventory price index computed for each pool is 1.0 plus a stated percentage of the increase since the base date in the weighted average pool index determined under paragraph (e)(3)(iii)(E)(*1*) of this section. In the case of an eligible small business as defined in section 474, the stated percentage is 100%. In the case of all other taxpayers, the stated percentage is 80%. Thus, the inventory price index for an eligible small business is equal to the weighted average pool index determined under paragraph (e)(3)(iii)(E)(*1*) of this section. The inventory price index for all other taxpayers is computed using the following formula: 1 + [0.8 * (weighted average pool index - 1)].

(*3*) *Link-chain IPIC method*. Under the link-chain IPIC method, an inventory price index for each pool is 1.0 plus a stated percentage of the increase since the base date in a cumulative index. In the case of an eligible small business as defined in section 474, the stated percentage is 100%. In the case of all other taxpayers, the stated percentage is 80%. The cumulative index for each taxable year is the product of the weighted average pool index determined under paragraph (e)(3)(iii)(E)(1) of this section multiplied by the cumulative index for the immediately preceding taxable year. The cumulative index for the taxable year is computed using the following formula: (weighted average pool index * preceding year's Cumulative Index). The inventory price index for a taxable year of an eligible small business is equal to the cumulative index for the taxable year. The inventory price index for a taxable year of all other taxpayers is computed using the following formula: 1 + [0.8 * (Cumulative Index for the taxable year - 1)].

(F) *Examples*. The following examples illustrate the rules of this paragraph (e)(3)(iii):

Example 1. Double-extension Method. (i) *Introduction*. R is a retail furniture merchant with more than $5,000,000 in average annual gross receipts for all relevant years. For the taxable year ending December 31, 1996, R used the first-in, first-out method of identifying inventory and valued its inventory at cost. R's inventory on December 31, 1996, had a cost of $850,000.00. R elected to use the dollar-value LIFO and double-extension IPIC methods for its taxable year ending December 31, 1997. R determines the current-year cost of inventory items by reference to the actual cost of the goods most recently purchased. R elected to pool its inventory in accordance with the special IPIC pooling rules of paragraph (b)(4) of this section. R does not use the retail inventory method. All of R's inventory items fall within the 2-digit commodity code in Table 6 (Producer price indexes for commodity groups, subgroups, product classes, and individual items) of the "PPI Detailed Report" for "furniture and household durables." Therefore, R will maintain a single inventory pool.

(ii) *Select a BLS table and appropriate month for the 1997 taxable year*. R determines that the appropriate month for the taxable year ending December 31, 1997, is October. Because R is a retailer not using the retail inventory method, R must select indexes from the "PPI Detailed Report." The indexes in Table 6 of the "PPI Detailed Report" are appropriate for R's inventory.

(iii) *Select index categories for the 1997 taxable year*. R's inventory items can be classified into five detailed categories listed in Table 6 of the "PPI Detailed Report" published for October, 1997. The categories and current-year cost of items in those categories can be summarized as follows:

Commodity Code	*Category*	*Current-Year Cost*
12120101	Living Room Table	$111,924.00
12120211	Dining Room Table	$159,578.00
12120216	Dining Room Chairs	$ 98,639.00
12130101	Upholstered Sofas	$332,488.00
12130111	Upholstered Chairs	$218,751.00
		$921,380.00

(iv) *Compute appropriate indexes for the 1997 taxable year*. Because R elected to use the double-extension IPIC method, R will compute appropriate indexes in accordance with paragraph (e)(3)(iii)(D)(*1*) of this section (published cumulative index for October, 1997 divided by published cumulative index for December, 1996). R computes the appropriate indexes as follows:

Category	*Oct. '97 Index*	*Dec. '96 Index*	*Appropriate Index*
Living Room Table	172.4	169.2	1.018913
Dining Room Table	171.9	168.1	1.022606
Dining Room Chairs	172.8	169.7	1.018268
Upholstered Sofas	142.2	140.9	1.009226
Upholstered Chairs	134.1	132.5	1.012075

(v) *Compute a weighted average pool index for the 1997 taxable year*. R must first compute a weighted average pool index using the formula set forth in paragraph (e)(3)(iii)(E)(*1*) of this section (Sum of weights / Sum of [Weight / Appropriate Index]). The weighted average pool index is computed as follows:

Category	*Weight*	*Appropriate Index*	*Quotient*
Living Room Table	$111,924.00	1.018913	$109,846.47
Dining Room Table	159,578.00	1.022606	156,050.33
Dining Room Chairs	98,639.00	1.018268	96,869.39
Upholstered Sofas	332,488.00	1.009226	329,448.51
Upholstered Chairs	218,751.00	1.012075	216,141.10
Total	$921,380.00		$908,355.80

Sum of Weights	*Sum of (Weight/Appropriate Index)*	*Weighted Average Pool Index*
$921,380.00	$908,355.80	1.0143382

(vi) *Compute an inventory price index for the 1997 taxable year. R computes an inventory price index for the pool using the formula s*et forth in paragraph (e)(3)(iii)(E)(2) of this section. The inventory price index is 1.0114710 (1 + [0.8 * (1.0143382 - 1)]).

(vii) *Determine the LIFO value of the pool for the 1997 taxable year*. R determines the total base-year cost of its ending inventory by dividing the total current-year cost of the inventory items in the pool by the inventory price index. The total base-year cost of R's ending inventory is $910,930.71 ($921,380 / 1.011471). R compares the ending inventory at base-year cost to the beginning inventory at base-year cost and determines that the amount of the layer of increment for the taxable year in terms of base-year cost is $60,930.71 ($910,930.71 - $850,000.00). R multiplies the base-year cost of the increment by the inventory price index computed for the taxable year and determines that the LIFO value of the increment is $61,629.65 ($60,930.71 * 1.011471). Thus, the LIFO value of R's inventory at the end of the 1997 taxable year is $911,629.65 ($850,000 opening inventory + $61,629.65 increment).

(viii) *Select a BLS table and appropriate month for the 1998 taxable year*. For the 1998 taxable year, R must compute a new inventory price index under the double-extension IPIC method to determine the LIFO value of its dollar-value pool. R determines that the appropriate month for the taxable year ending December 31, 1998, is November.

(ix) *Select index categories for the 1998 taxable year*. The inventory items contained in R's ending inventory can be classified into five detailed categories listed in Table 6 of the "PPI Detailed Report" published for November, 1998. The categories and current-year cost of items in those categories can be summarized as follows:

Commodity Code	*Category*	*Current-Year Cost*
12120103	Living Room Desks	$125,008.00
12120211	Dining Room Table	$136,216.00
12120216	Dining Room Chairs	$113,569.00
12130101	Upholstered Sofas	$343,900.00
12130111	Upholstered Chairs	$233,050.00
		$951,743.00

(x) *Compute appropriate indexes for the 1998 taxable year*. Because R uses the double-extension IPIC method, R will compute an appropriate index in accordance with paragraph (e)(3)(iii)(D)(1) of this section (published cumulative index for November, 1998 divided by published cumulative index for December, 1996). R computes the appropriate indexes as follows:

Category	Nov. '98 Index	Dec. '96 Index	Appropriate Index
Living Room Desks	172.6	160.3	1.076731
Dining Room Table	174.8	168.1	1.039857
Dining Room Chairs	177.0	169.7	1.043017
Upholstered Sofas	144.9	140.9	1.028389
Upholstered Chairs	136.6	132.5	1.030943

(xi) *Compute a pool index for the 1998 taxable year*. R must first compute a weighted average pool index using the formula set forth in paragraph (e)(3)(iii)(E)(*1*) of this section (Sum of weights / (Sum of [Weight / Appropriate Index])). The weighted average pool index is computed as follows:

Category	Weight	Appropriate Index	Quotient
Living Room Desks	$125,008.00	1.076731	$116,099.56
Dining Room Table	136,216.00	1.039857	130,994.93
Dining Room Chairs	113,569.00	1.043017	108,885.09
Upholstered Sofas	343,900.00	1.028389	334,406.53
Upholstered Chairs	233,050.00	1.030943	226,055.17
Total	$951,743.00		$916,441.28

Sum of Weights	Sum of (Weight/Appropriate Index)	Weighted Average Pool Index
$951,743.00	$916,441.28	1.0385204

(xii) *Compute an inventory price index for the 1997 taxable year*. R computes the inventory price index for the pool using the formula set forth in paragraph (e)(3)(iii)(E)(*2*) of this section. The inventory price index is 1.0308163 (1 + [0.8 * (1.0385204 - 1)]).

(xiii) *Determine the LIFO value of the pool for the 1998 taxable year*. R determines the total base-year cost of its ending inventory by dividing the total current-year cost of the inventory items in the pool by the pool index. The total base-year cost of the ending inventory is $923,290.60 ($951,743.00 / 1.0308163). R compares the ending inventory at base-year cost to the beginning inventory at base-year cost and determines that the amount of the layer of increment for the taxable year in terms of base-year cost is $12,359.89 ($923,290.60 - $910,930.71). R multiplies the base-year cost of the increment by the pool index computed for the taxable year and determines that the LIFO value of the increment is $12,740.78 ($12,359.89 * 1.0308163). Thus, the LIFO value of R's inventory at the end of the 1997 taxable year is $924,370.43 ($850,000.00 base year layer + $61,629.65 1997 layer + $12,740.78 1998 layer).

Example 2. Link-chain Method. (i) *Introduction*. The facts are the same as *Example 1*, except that R uses the link-chain IPIC method. The double-extension IPIC method and the link-chain IPIC method yield the same results for the first taxable year in which the IPIC method is used. Therefore, this example only illustrates how R would compute an inventory price index and determine the LIFO value of its dollar-value pool for the 1998 taxable year.

(ii) *Select a BLS table and appropriate month for the 1998 taxable year*. R determines that the appropriate index month for the taxable year ending December 31, 1998, is November.

(iii) *Select index categories for the 1998 taxable year*. R's inventory items can be classified into five detailed categories listed in Table 6 of the "PPI Detailed Report" published for November, 1998. The categories and current-year cost of items in those categories can be summarized as follows:

Commodity Code	Category	Current-Year Cost
12120103	Living Room Desks	$125,008.00
12120211	Dining Room Table	$136,216.00
12120216	Dining Room Chairs	$113,569.00
12130101	Upholstered Sofas	$343,900.00
12130111	Upholstered Chairs	$233,050.00
		$951,743.00

(iv) *Compute appropriate indexes for the 1998 taxable year.* Because R uses the link-chain IPIC method, R will compute an appropriate index in accordance with paragraph (e)(3)(iii)(D)(2) of this section (published cumulative index for the November, 1998 divided by published cumulative index for the October, 1997). R computes the appropriate indexes as follows:

Category	Nov. '98 Index	Oct. '97 Index	Appropriate Index
Living Room Desks	172.6	162.0	1.065432
Dining Room Table	174.8	171.9	1.016870
Dining Room Chairs	177.0	172.8	1.024306
Upholstered Sofas	144.9	142.2	1.018987
Upholstered Chairs	136.6	134.1	1.018643

(v) *Compute a pool index for the 1998 taxable year*. R must first compute a weighted average pool index using the formula set forth in paragraph (e)(3)(iii)(E)(1) of this section (Sum of weights / Sum of [Weight / Appropriate Index]). The weighted average pool index is computed as follows:

Category	*Weight*	*Appropriate Index*	*Quotient*
Living Room Desks	$125,008.00	1.065432	$117,330.81
Dining Room Table	136,216.00	1.016870	133,956.16
Dining Room Chairs	113,569.00	1.024306	110,874.09
Upholstered Sofas	343,900.00	1.018987	337,492.04
Upholstered Chairs	233,050.00	1.018643	228,784.77
Total	$951,743.00		$928,437.87

Sum of Weights	*Sum of (Weight/Appropriate Index)*	*Weighted Average Pool Index*
$951,743.00	$928,437.87	1.0251014

(vi) *Compute an inventory price index for the 1997 taxable year*. R computes the inventory price index in accordance with paragraph (e)(3)(iii)(E)(3) of this section. R multiplies the weighted average pool index by the prior year's cumulative index to get the cumulative index for the taxable year. Because 1997 was the first year in which R used the link-chain IPIC method, the prior year's cumulative index is equal to the 1997 weighted average pool index. The cumulative index for 1998 is 1.0397995 (1.0143382 * 1.0251014). R computes the inventory price index using the formula set forth in paragraph (e)(3)(iii)(E)(3) of this section. The inventory price index is 1.0318396 (1 + [0.80 * (1.0397995 - 1)]).

(vii) *Determine the LIFO value of the pool for the 1998 taxable year*. R determines the total base-year cost of its ending inventory by dividing the total current-year cost of the inventory items in the pool by the inventory price index. The total base-year cost of the ending inventory is $922,374.95 ($951,743.00 / 1.0318396). R compares the ending inventory at base-year cost to the beginning inventory at base-year cost and determines that the amount of the layer of increment for the taxable year in terms of base-year cost is $11,444.24 ($922,374.95 - $910,930.71). R multiplies the base-year cost of the increment by the pool index computed for the taxable year and determines that the LIFO value of the increment is $11,808.62 ($11,444.24 * 1.0318396). Thus, the LIFO value of R's inventory at the end of the 1998 taxable year is $923,438.27 ($850,000 base year layer + $61,629.65 1997 layer + $11,808.62 1998 layer).

(iv) *Adoption or change of method*—(A) *Adoption or change to IPIC method.* The use of an inventory price index computed using the IPIC method is a method of accounting. A taxpayer permitted to adopt the dollar-value LIFO method without first securing the consent of the Commissioner may also adopt the IPIC method incident to that adoption without first securing the consent of the Commissioner. The IPIC method may be adopted and used only if the taxpayer indicates on a Form 970, "Application to Use LIFO Inventory Method," or in such other manner as may be acceptable to the Commissioner, a listing of each dollar-value inventory pool, the type of goods included in each pool, the consumer or producer price index or indexes selected for each pool, whether the taxpayer will use the double-extension IPIC method or the link-chain IPIC method of computing an inventory price index, and if the taxpayer makes a one-time binding election of an appropriate representative month, the representative month. In the case of a taxpayer permitted to adopt the IPIC method without requesting the Commissioner's consent, the Form 970 shall be attached to the taxpayer's income tax return for the taxable year of that adoption. In all other cases, a taxpayer may change to the IPIC method prescribed by this paragraph only after first securing the consent of the Commissioner as provided in §1.446-1(e). In such cases, the Form 970 containing the information described above must be attached to a Form 3115, "Application for Change in Accounting Method," filed in accordance with §1.446–1(e). Taxpayers must maintain adequate books and records in order to satisfy the requirements of §1.472–2(h), including adequate books and records of the use and computations of the IPIC method. Notwithstanding the rules in paragraph (e)(1) of this section, a taxpayer that adopts or changes to the use of an inventory price index computed using the IPIC method is not required to demonstrate that the use of any other method of computing the LIFO value of a dollar-value inventory pool is impractical.

(B) *Change in selected index.* The selection of a consumer or producer price index category for a specific item to compute an appropriate index under paragraph (e)(3)(iii)(B) of this section is a method of accounting. A taxpayer desiring to change the selection of such a consumer or producer price index must secure the consent of the Commissioner as provided in §1.446–1(e).

(C) *New base year*—(*1*) *Voluntary change*—(*i*) *In general.* In the case of a taxpayer using a method other than the IPIC method to determine the LIFO value of a dollar-value inventory pool, any layers of inventory increments previously determined by that method and the LIFO value of those layers are retained if the taxpayer voluntarily changes to the use of the IPIC method. In the case of a taxpayer changing the selection of an index category for an inventory item, any layers of inventory increments previously determined and the LIFO value of those layers are retained. Instead of using the earliest taxable year for which the taxpayer adopted the LIFO method for any items in the pool, the year of change is used as the new base year in determining the LIFO value of the inventory pool for the year of change and later taxable years. The cumulative index as of the first day of the year of change (the base date) is 1.00. The base-year costs of layers of increment in the pool at the beginning of the year of change must be restated in terms of new base-year cost, using the year of change as the new base year, and the indexes for previously determined inventory increments must be recomputed accordingly. The new base-year cost of a pool is equal to the total current-year cost of all the items in the pool as determined pursuant to the taxpayer's established method of determining the total current-year cost of items making up the pool under paragraph (e)(2)(ii) of this section. See paragraph (f)(2) of this section for rules relating to a change to the dollar-value method from another method of pricing LIFO inventories.

(*ii*) *Example.* The following example illustrates the rules of this paragraph (e)(3)(iv)(C)(*1*):

Example. (i) X began using a dollar-value LIFO method other than the IPIC method in 1990 and main-

tains a single dollar-value pool. X is granted permission to change to the IPIC method, beginning with the taxable year ending December 31, 2000. X will continue to use a single dollar-value pool under the IPIC method. X's beginning inventory as of January 1, 2000, computed using its former method, is as follows:

	Base-Year Costs	*Index*	*LIFO Value*
Base layer	$135,000	1.00	$135,000
1991 layer	20,000	1.43	28,600
1994 layer	60,000	1.55	93,000
1995 layer	13,000	1.59	20,670
1997 layer	2,000	1.61	3,220
Totals	$230,000		$280,490

(ii) Under X's method of determining the current-year cost of items, the current-year cost of the beginning inventory is $391,000. Thus, X's new base-year cost as of January 1, 2000 is $391,000. X allocates this new base-year cost to each LIFO layer based on the ratio of old base-year cost of the layer to the total old base-year cost of the pool. To recompute the indexes for each of its LIFO layers, X divides the LIFO value of each layer by the new base-year cost attributable to the layer. The new base-year costs, recomputed indexes, and LIFO value of X's inventory are as follows:

	Base-Year Costs	*Index*	*LIFO Value*
Base layer	$229,500	0.588235	$135,000
1991 layer	34,000	0.841176	28,600
1994 layer	102,000	0.911765	93,000
1995 layer	22,100	0.935294	20,670
1997 layer	3,400	0.947059	3,220
Totals	$391,000		$280,490

(*2*) *Involuntary change*—(*i*) *In general.* If a taxpayer uses a method of accounting other than the IPIC method to determine the LIFO value of a dollar-value inventory pool and the Commissioner determines that the method does not clearly reflect income, the Commissioner may require the taxpayer to change to the IPIC method. If a taxpayer is unable to provide a sufficient basis, including information from its books and records, to compute an adjustment under section 481, and the Commissioner requires the taxpayer to change to the IPIC method, the Commissioner will require the taxpayer to change to the double-extension IPIC method and implement the change on a cut-off basis without a new base year. Under the cut-off basis without a new base year, the Commissioner will determine the amount of any increment in terms of base-year cost for the year of change by comparing the total base-year cost of the beginning inventory under the taxpayer's method and the total base-year cost of the ending inventory under the double-extension IPIC method described in this paragraph (e)(3) and value any increment so determined using the inventory price index computed under the double-extension IPIC method.

(*ii*) *Example.* The following example illustrates the rules of this paragraph (e)(3)(iv)(C)(*2*):

Example. (i) Y began using a dollar-value LIFO method other than the IPIC method in 1994 and maintains a single dollar-value pool. Under Y's method of determining the current-year cost of items, the current-year cost of Y's ending inventory for the 2000 taxable year is $348,160. Y's beginning inventory as of January 1, 2000, computed using its method, is as follows:

	Base-Year Costs	*Index*	*LIFO Value*
Base layer	$105,000	1.00	$105,000
1995 layer	3,000	1.70	5,100
1996 layer	5,500	2.00	11,000
1997 layer	2,900	2.50	7,250
1998 layer	1,400	2.85	3,990
Totals	$117,800		$132,340

(ii) Upon examination, it is determined that Y's dollar- value LIFO method does not clearly reflect income. If Y is unable to provide the examining agent with a sufficient basis to compute a section 481 adjustment arising from a change to a dollar-value LIFO method that does clearly reflect income, and the examining agent chooses to change Y to the IPIC method, the change will be implemented as follows. First, the examining agent will compute an inventory price index under the double-extension IPIC method in accordance with this paragraph (e)(3). For purposes of this example, assume that the inventory price index computed under the double-extension IPIC method is 1.438793. Second, the examining agent will divide the current-year cost of Y's ending inventory by the inventory price index to determine the base-year cost of Y's inventory under the double-extension IPIC method. The base-year cost is $241,980.60 ($348,160 / 1.438793). Third, the examining agent will compare the base-year cost of the ending inventory determined under the double-extension IPIC method to the base-year cost of the beginning inventory determined under Y's method of accounting to determine the amount of any increment. The increment at base- year cost for the 2000 taxable year is $124,180.60 ($241,980.60 - $117,800.00). Fourth, the examining agent will value the increment by multiplying the base-year cost of the increment by the inventory price index. The LIFO value of the increment is $178,670.18 ($241,980.60 * 1.438793). Finally, the examining agent will reduce Y's cost of goods sold and increases Y's gross income for the 2000 taxable year by the increase in the LIFO value of the 2000 ending inventory, or $178,670.18.

(v) *Effective date*—(A) *In general*. The rules of this paragraph (e)(3) and paragraphs (b)(4) and (c)(2) of this section are applicable for taxable years beginning on or after the date these regulations are published in the **Federal Register** as final regulations.

(B) *Change in method of accounting*. Any change in a taxpayer's method of accounting necessary to comply with this paragraph (e)(3) or paragraphs (b)(4) or (c)(2) of this section is a change in method of accounting to which the provisions of section 446 and the regulations thereunder apply. For the first taxable year beginning on or after the date these regulations are published in the **Federal Register** as final regulations, a taxpayer is granted the consent of the Commissioner to change its method of accounting to a method required or permitted by this paragraph (e)(3) and paragraphs (b)(4) and (c)(2) of this section. A taxpayer that wants to change its method of accounting under this paragraph (e)(3)(v) must follow the automatic consent procedures in Rev. Proc. 99–49 (1999–52 I.R.B. 725)(see §601.601(d)(2) of this chapter). However, the scope limitations in section 4.02 of Rev. Proc. 99–49 do not apply. In addition, if the taxpayer's method of accounting for its LIFO inventories is an issue under consideration at the time the application is filed with the national office, the audit protection of section 7 of Rev. Proc. 99–49 does not apply. If a taxpayer changing its method of accounting under this paragraph (e)(3)(v)(B) 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 application to the examining agent(s), appeals officer or counsel for the government, as appropriate, at the same time it files the application with the national office. A change under this paragraph (e)(3)(v)(B) must be made using a cut-off basis and new base year in accordance with paragraph (e)(3)(iv)(C)(*1*) of this section. Because a change under this paragraph (e)(3)(v)(B) is made on a cut-off basis, a section 481(a) adjustment is not required. However, a taxpayer changing its method of accounting under this paragraph (e)(3)(v)(B) must comply with the requirements of section 10.04(3) of the APPENDIX of Rev. Proc. 99–49 (concerning bargain purchases).

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(h) *Inventories received in certain nonrecognition transactions*—(1) *In general*. Except as provided in paragraph (h)(3) of this section, if inventories are received in a transaction described in paragraph (h)(2) of this section, then for purposes of determining future increments and liquidations the transferee must use the year of the transfer as the base year and the current-year cost (determined under the transferor's method of accounting) of the inventories received as the new base-year cost of such inventories. Likewise, the transferee must use the current-year cost (determined under the transferee's method of accounting) of its beginning inventory, if any, as the new base-year cost of the beginning inventory for purposes of determining future increments and liquidations. The total new base-year cost of the transferee's beginning inventory is equal to the new base-year cost of the inventories received and the new base-year cost of the beginning inventory. The cumulative index as of the first day of the year in which the inventory is received (the base date) is 1.00. The base-year costs of any layers of increment in the pool, as determined after the transfer, must be restated in terms of new base-year costs and the indexes for all such layers must be restated in terms of the new base year index. See paragraph (e)(3)(iv)(C)(*1*) of this section for an example of this computation.

(2) *Transactions to which this paragraph (h) applies*. A transaction is described in this paragraph (h) if—

(i) The transferee determines its basis in the inventories, in whole or in part, by reference to the basis of the inventories in the hands of the transferor;

(ii) The transferor used the dollar-value LIFO method to account for the transferred inventories;

(iii) The transferee uses the dollar-value LIFO method to account for the inventories in the year of the transfer; and

(iv) The transaction is not described in section 381(a).

(3) *Anti-avoidance rule*. The rule in paragraph (h)(1) of this section will not apply to a transaction entered into with the principal purpose to avail the transferee of a method of accounting that would be unavailable to the transferor (or would be unavailable to the transferor without securing consent from the Commissioner). In determining the principal purpose of a transfer, consideration will be given to all of the facts and circumstances. However, a transfer is deemed made with the principal purpose to avail the transferee of a method of accounting that would be unavailable to the transferor without securing consent from the Commissioner if the transferor acquired inventory in a bargain purchase within the five taxable years preceding the year of the transfer and used a dollar-value LIFO method to account for that inventory that did not treat the bargain purchase inventory and physically identical inventory acquired at market prices as separate items. Inventory is deemed acquired in a bargain purchase if the actual cost of the inventory (or, if appropriate, the allocated cost of the inventory) was less than or equal to 50 percent of the replacement cost of physically identical inventory. Inventory is not considered acquired in a bargain purchase if the actual cost of the inventory (or, if appropriate, the allocated cost of the inventory) was greater than or equal to 75 percent of the replacement cost of physically identical inventory.

(4) *Effective date*. The rules of this paragraph (h) are applicable for transfers on or after the date these regulations are published in the **Federal Register** as final regulations.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

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