

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part 1, §§ 263A, 446, 471, 472, 481, 7121; 1.263A-1, 1.446-1, 1.471-2, 1.471-4,
1.472-2, 1.481-1)

Rev. Proc. 2003-20

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor method of accounting (the “Core Alternative Valuation” (CAV) method) for remanufacturers and rebuilders of motor vehicle parts (“remanufacturers”) and resellers of remanufactured and rebuilt motor vehicle parts (“resellers”) that use the lower of cost or market (LCM) inventory valuation method to value their inventory of cores held for remanufacturing or sale. The CAV method is provided by the Commissioner pursuant to his authority under § 446 of the Internal Revenue Code in order to minimize disputes, provide certainty, and simplify inventory computations. This revenue procedure also provides a procedure for qualifying remanufacturers and resellers currently using an LCM method to obtain automatic consent of the Commissioner to change to the CAV method. In addition, this revenue procedure provides a procedure for qualifying remanufacturers and resellers not currently using an LCM method to obtain automatic consent to change to an LCM method in conjunction with a change to the CAV method.

SECTION 2. BACKGROUND

.01 *In General.*

(1) Remanufacturers acquire inventories of used motor vehicle parts (e.g., wiper motors, engines, transmissions, and alternators for automobiles, trucks, buses, etc.) for use in remanufacturing. These used parts are frequently referred to within the remanufacturing industry as “cores.” Remanufacturers rebuild motor vehicle parts from cores through use of new and used component parts and sell the resulting products as remanufactured replacement parts. Resellers acquire cores in conjunction with their resale activity and sell the cores to a remanufacturer or another reseller in the distribution chain.

(2) Remanufacturers and resellers acquire cores from customers (“customer cores”) who purchase remanufactured replacement parts. To encourage a customer to return the core, remanufacturers and resellers generally offer the customer a credit (offset against the purchase price). Remanufacturers and resellers also acquire cores from third-party suppliers of cores (businesses that specialize in supplying cores to meet specific needs, referred to within the industry as “core suppliers” or “core brokers”) and occasionally acquire cores directly from other sources.

(3) Controversy exists as to the proper market valuation of cores under the LCM method. See *Consolidated Manufacturing, Inc. v. Commissioner*, 249 F.3d 1231 (10th Cir. 2001), *rev'g in part*, 111 T.C. 1 (1998). In order to reduce controversy and minimize disputes, the Service has determined that it is appropriate to provide a safe harbor procedure for the LCM valuation of cores in inventory.

.02 Section 471 of the Internal Revenue Code, which governs the treatment of inventories, provides two tests to which each inventory must conform: (1) it must

conform as nearly as may be to the best accounting practice in the trade or business; and (2) it must clearly reflect income. Section 1.471-2(c) of the Income Tax Regulations provides that the bases of valuation most commonly used by business concerns and which meet the requirements of § 471 are (1) cost and (2) cost or market, whichever is lower. Section 1.471-2(c) also provides that any goods in an inventory that are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued, if such goods consist of raw materials held for use or consumption, upon a reasonable basis taking into consideration the usability and condition of the goods, but in no case shall such value be less than the scrap value.

.03 Section 1.471-3(b) defines the cost of merchandise purchased since the beginning of the taxable year as the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted, or not, at the option of the taxpayer, provided the taxpayer follows a consistent course. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods. In the case of merchandise produced by the taxpayer, § 1.471-3(c) defines cost as (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to, and necessary for, the production of the particular article, including in such indirect production costs an appropriate portion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit. See §§ 1.263A-1 and 1.263A-2 for more specific

rules regarding the treatment of production costs.

.04 Section 1.471-4(a) provides that, under ordinary circumstances and for normal goods in inventory, “market” means the aggregate of the current bid prices prevailing at the date of the inventory of the basic elements of cost reflected in inventories of goods purchased and on hand, goods in process of manufacture, and finished manufactured goods on hand. The basic elements of cost include direct materials, direct labor, and indirect costs required to be included in inventories by the taxpayer (e.g., under § 263A and its underlying regulations for taxpayers subject to that section). For taxpayers to which § 263A applies, for example, the basic elements of cost must reflect all direct costs and all indirect costs properly allocable to goods on hand at the inventory date at the current bid price of those costs, including but not limited to the cost of purchasing, handling, and storage activities conducted by the taxpayer, both prior to and subsequent to acquisition or production of the goods.

.05 Section 1.471-4(c) provides that if inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

.06 Section 1.471-2(f) provides deducting from inventory a reserve for price changes, or an estimated depreciation in the value of the inventory, is not in accord with the regulations underlying § 471.

.07 Section 472(b) and § 1.472-2 require taxpayers using the last-in, first-out (LIFO) method to inventory their goods at cost.

.08 Section 446(e) and § 1.446-1(e)(2)(i) require that, except as otherwise expressly

provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the terms and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with § 446(e).

SECTION 3. SCOPE

.01 *Applicability.* This revenue procedure applies to remanufacturers and resellers that want to change to the CAV method described in section 4 of this revenue procedure to value inventories of cores. For purposes of this revenue procedure, “cores” include electrical, mechanical, hydraulic, and other operating motor vehicle parts, including parts of automobiles, trucks, buses, motorcycles, boats, construction equipment, farm machinery, and other on- and off-road motorized equipment. The CAV method applies only to cores held in inventory for remanufacturing or, in the case of a reseller, held for sale to a remanufacturer or another entity in the distribution chain. The CAV method only applies to cores valued under the LCM method.

.02 *Inapplicability.* This revenue procedure does not apply to a taxpayer that values its inventory of cores at cost (including a taxpayer using the LIFO method) unless the taxpayer concurrently changes (under section 6.02 of this revenue procedure) from cost to the LCM method for its cores (including labor and overhead related to the cores in raw materials, work-in-process and finished goods). A taxpayer that wants to concurrently change from cost to the LCM method must: (a) not be otherwise prohibited from using the LCM method; (b) comply with the general rules relating to inventories under § 471 and the regulations thereunder; and (c) in the case of taxpayers using the

LIFO method, use the LCM method and a permitted method for identification as determined and defined in section 10.01(1)(b) of the APPENDIX of Rev. Proc. 2002-9, 2002-3 I.R.B. 327, 368-69.

SECTION 4. THE CORE ALTERNATIVE VALUATION METHOD

.01 In General.

(1) A taxpayer using the CAV method values its inventory of cores at LCM, determines cost in accordance with section 4.02 of this revenue procedure, and determines market in accordance with section 4.03 of this revenue procedure.

(2) The CAV method will be a permissible method of accounting provided the taxpayer follows the rules and computational methodology described in sections 4.02 through 4.05 of this revenue procedure and, if the taxpayer is changing from another method to the CAV method, the provisions of section 6 of this revenue procedure regarding changes in method of accounting. All computations under the CAV method, however, are subject to verification upon examination of the taxpayer's income tax returns.

.02 Determination of Cost.

(1) *In general.* Under the CAV method, the taxpayer is required to use as the cost of each core in ending inventory the invoice price adjusted, as appropriate, for discounts, freight costs, and other direct and indirect costs properly allocable to the cores as described in §§ 1.471-3 and 1.263A-1. If the core was acquired from a core supplier or broker, the invoice price is the amount paid to the core supplier or broker. If the core was acquired from a customer, the invoice price is the sum of any credit allowed to the customer and any amount paid to the customer. *Consolidated*

Manufacturing, Inc. v. Commissioner, 249 F.3d 1231 (10th Cir. 2001), *aff'd on this issue*, 111 T.C. 1 (1998).

(2) *Service may redetermine appropriate cost.* As a general rule, the taxpayer must follow the form that the taxpayer used for the transaction. See, for example, *In re Steen*, 509 F.2d 1398, 1402 n. 4 (9th Cir. 1975) and *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967). If the Service determines, however, that the taxpayer's use of the credit amount as the invoice price does not clearly reflect income (for example, because the taxpayer artificially inflated both the price of the remanufactured core and the credit amount solely to manipulate gross receipts for tax avoidance), the Service may examine the substance of the transaction to determine the appropriate cost for a core. See, for example, *Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935).

.03 *Determination of Market Value.*

(1) *In general.* Under the CAV method, the market value under § 1.471-4 of each core in ending inventory is the "allowable supplier price" adjusted, as appropriate, for other direct and indirect costs properly allocable to the core as described in §§ 1.471-4 and 1.263A-1. The allowable supplier price will be considered to be the replacement cost for purposes of §§ 1.471-4 and 1.263A-1.

(2) *Allowable supplier price.* For purposes of this revenue procedure the "allowable supplier price" is the amount the taxpayer would pay in an arm's length transaction to acquire a particular core from a core supplier or core broker, plus the related transportation cost that would be incurred to acquire possession of the core from the core broker or supplier at year-end. If the taxpayer has purchased a particular type of

core from several core suppliers or core brokers during the tax year, the allowable supplier price for that core type will be deemed to be the weighted-average price, including transportation cost, the taxpayer would have to pay in an arm's length transaction to acquire the particular core type at year-end from the core suppliers or core brokers from whom the cores were purchased during the tax year. If the taxpayer has not purchased a particular core type from a core supplier or core broker during the tax year, the taxpayer must identify its largest (in dollar terms) supplier of cores during the current tax year that also sells the particular core type in the ordinary course of its business; the allowable supplier price will be the arm's length price from that supplier for the core type at year-end plus the transportation cost that would be incurred to acquire the core type from that supplier. If none of the taxpayer's suppliers sell the particular core type, the taxpayer must reasonably determine the allowable supplier price based on the arm's length price for the core type at year-end, plus the transportation cost, in the geographical area or market in which the taxpayer regularly participates. In any case, no further adjustments will be allowed in determination of allowable supplier price.

(3) Example of allowable supplier price calculation using weighted-average price.

Taxpayer, a remanufacturer, had 4 units of Part X customer cores in inventory at year-end. Taxpayer acquired these customer cores from customers in transactions in which taxpayer sold to the customers remanufactured parts and received cores from the customers in exchange for credits toward the purchase price of the remanufactured parts. During the tax year, Taxpayer purchased 8 units of Part X cores from suppliers (2 units of Part X from Core Supplier A and 6 units of Part X from Core Supplier B). Therefore, Taxpayer purchased 25% (2 of 8 units) of the total number of Part X

acquired for the year from Core Supplier A and 75% (6 of 8 units) of the total number of Part X acquired for the year from Core Supplier B. At the end of the taxable year, the price Taxpayer would have to pay in an arm's length transaction to acquire Part X, including transportation cost, was \$20 from Core Supplier A and \$16 from Core Supplier B. Taxpayer would determine the allowable supplier price for Part X customer cores under the CAV method as follows:

	# of Units Purchased During Year	% of Total Units Purchased During Year	End of Year Price
Core Supplier A	2	25%	\$20
Core Supplier B	<u>6</u>	75%	\$16
Total	<u>8</u>		

CAV Core Supplier Price for Part X Customer Cores = $(25\% \times \$20) + (75\% \times 16) = \17 .

.04 Comparison of Cost and Market. Under the CAV method, the market value of each core in ending inventory, as determined under section 4.03 of this revenue procedure, shall be compared with the cost of each core in ending inventory, as determined under section 4.02 of this revenue procedure, and the lower of such values shall be the inventory value of the core. This analysis must be performed on a part-by-part basis.

.05 Write-down of Defective Cores. Under the CAV method, a taxpayer may not reduce the value of a defective core under § 1.471-2(c) until the taxpayer discovers that the core is subnormal and scraps the core or offers the core for sale at a bona fide selling price that is less than cost. In no case may a taxpayer value a core at less than the scrap value. A taxpayer may not reduce the value of cores based on anticipated defect percentages or historical defect experience rates. If a taxpayer complies with the requirements of this revenue procedure, the Service will not disallow a write-down of a

defective core in the year it is scrapped on the grounds that the decline in the value of the core actually occurred in a preceding taxable year.

SECTION 5. AUDIT PROTECTION FOR TAXPAYERS CURRENTLY USING THE SAFE HARBOR METHOD

If a taxpayer within the scope of this revenue procedure was consistently using the CAV method provided in section 4 of this revenue procedure before February 10, 2003, the taxpayer's use of the CAV method will not be raised by the Service as an issue in a taxable year that ends before February 10, 2003. Moreover, if such taxpayer's use of the CAV method has already been raised as an issue in examination, appeals, or before the Tax Court in a taxable year that ends before February 10, 2003, the issue will not be further pursued by the Service.

SECTION 6. CHANGES IN METHOD OF ACCOUNTING

.01 In General. A change in the treatment of customer cores in inventory to the CAV method provided by this revenue procedure is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply.

Therefore, a taxpayer within the scope of this revenue procedure that wishes to change to the CAV method for a taxable year ending on or after December 31, 2002, must file a Form 3115, Application for Change in Accounting Method.

.02 Automatic Change for Taxpayers Within the Scope of this Revenue Procedure.

(1) *Automatic change to the CAV method.* A taxpayer within the scope of this revenue procedure that wants to change to the CAV method must follow the automatic change in accounting method provisions of Rev. Proc. 2002-9, as modified by Rev. Proc. 2002-19, 2002-13 I.R.B. 696, Announcement 2002-17, 2002-8 I.R.B. 561, and

Rev. Proc. 2002-54, 2002-35 I.R.B. 432, with the following modifications:

(a) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to a taxpayer that wants to change to the CAV method for its first taxable year ending on or after December 31, 2002, provided the taxpayer's method of accounting for cores is not an issue under consideration in examination (within the meaning of section 3.09 of Rev. Proc. 2002-9) at the time the Form 3115 is filed with the national office;

(b) In lieu of the label required by section 6.02(4) of Rev. Proc. 2002-9, taxpayers are instructed to write "Filed under Rev. Proc. 2003-20" at the top of the form; and

(c) Taxpayers making concurrent changes under subsections (2) or (3) of this section should include the concurrent change with the change to the CAV method in a single application.

(2) *Change from cost to LCM.* An automatic change in method of accounting to the CAV method under this revenue procedure also includes, where applicable, a concurrent change from the cost method to the LCM method.

(3) *Change from LIFO.* An automatic change in method of accounting to the CAV method under this revenue procedure also includes a concurrent change from the LIFO method to a permitted method for identification as determined and defined in section 10.01(1)(b) of the APPENDIX of Rev. Proc. 2002-9. A taxpayer that desires to discontinue LIFO to use the CAV method must make a concurrent change from its cost method to the LCM method.

SECTION 7. RECORD KEEPING

Section 6001 provides that every person liable for any tax imposed by the Code, or for the collection thereof, must keep such records, render such statements, make

such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. The books or records required by § 6001 must be kept at all times available for inspection by authorized internal revenue officers or employees, and must be retained so long as the contents thereof may become material in the administration of any internal revenue law. § 1.6001-1(e). In order to satisfy the record keeping requirements of § 6001 and the regulations thereunder, a taxpayer that uses the CAV method should maintain records supporting all aspects of its inventory valuation including but not limited to cost of supplier cores.

SECTION 8. EFFECT ON OTHER DOCUMENTS

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

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2002.

SECTION 10. DRAFTING INFORMATION

The principal authors of this revenue procedure are Willie E. Armstrong, Jr. and W. Thomas McElroy, Jr. of the Office of the Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure contact Mr. Armstrong or Mr. McElroy at (202) 622-4970 (not a toll free call).