Part III - Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 471; 1.471-2.)

Rev. Proc. 98-29

SECTION 1. PURPOSE

This revenue procedure provides guidance for a taxpayer that wants to change to a method of accounting for estimating inventory "shrinkage" in computing ending inventory. "Shrinkage" refers collectively to such items as undetected theft, breakage, and bookkeeping errors. In addition, section 4 of this revenue procedure provides interim guidance that describes the "retail safe harbor method" for a taxpayer that wants to change to the retail safe harbor method for estimating inventory shrinkage. The procedures for a taxpayer within the scope of this revenue procedure to automatically change to a method of accounting for estimating inventory shrinkage are provided in Rev. Proc. 97-37, 1997-33 I.R.B. 18, as modified by section 5.02 of this revenue procedure. This revenue procedure also requests comments on issues that should be addressed in forthcoming regulations under § 471 regarding proper methods of estimating inventory shrinkage for taxable years ending after August 5, 1997.

SECTION 2. BACKGROUND

.01 Section 471(a) of the Internal Revenue Code provides that whenever, in the opinion of the Secretary, the use of inventories is necessary in order to clearly determine the income of any taxpayer, inventories must be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

.02 Section 1.471-2(d) of the Income Tax Regulations provides that when a taxpayer maintains book inventories in accordance with a sound accounting system, the net value of the inventory will be deemed to be the cost basis of the inventory, provided that such book inventories are verified by physical inventories at reasonable intervals and adjusted to conform therewith. Physical inventories are used to determine and adjust book inventories for shrinkage.

.03 Section 961 of the Taxpayer Relief Act of 1997 (Act) amended § 471(b) to permit, under certain circumstances, adjustments to ending inventory for estimates of inventory shrinkage. Section 961(b) of the Act provides that, in the case of any taxpayer permitted by § 471(b) to change its method of accounting to a permissible method for any taxable year, the change is treated as made with the consent of the Secretary and the period for taking into account the adjustments under § 481 by reason of such change is four years.

.04 The legislative history (Conference Report and House Report) accompanying the Act provides that a taxpayer is permitted by § 471(b) to change its method of accounting if the taxpayer is currently using a method that does not utilize estimates of inventory shrinkage and wants to change to a method that includes inventory shrinkage estimates based on physical inventories taken at other than year-end. H.R. Rep. No. 220 (Conference Report), 105th Cong., 1st Sess. 466, at 467-68 (1997); H.R. Rep No. 2014 (House Report), 105th Cong., 1st Sess. 408, at 410 (1997). In addition, the Conference Report provides a safe harbor method applicable to taxpayers primarily engaged in retail trade (the "retail safe harbor method"). The Conference Report further provides that the conferees expect that the Secretary will provide procedures allowing a taxpayer to automatically change to the retail safe harbor method. Pursuant to the Conference Report, use of the retail safe harbor method will be deemed to result in a clear reflection of income, provided such safe harbor method is consistently applied and the taxpayer’s inventory methods otherwise satisfy the clear reflection of income standard.

SECTION 3. SCOPE

.01 Applicability. This revenue procedure applies to a taxpayer requesting the Commissioner’s consent to change to a method of accounting for estimating inventory shrinkage in computing ending inventory, using:

(1) the retail safe harbor method, regardless of whether the taxpayer’s present method of accounting estimates inventory shrinkage; or

(2) a method other than the retail safe harbor method, provided (a) the taxpayer’s present method of accounting does not estimate inventory shrinkage, and (b) the taxpayer’s new method of accounting (that estimates inventory shrinkage) clearly reflects income under § 446(b).

.02 Inapplicability. This revenue procedure does not apply to a taxpayer requesting to change to a method other than the retail safe harbor method of accounting for estimating inventory shrinkage in computing ending inventory, if the taxpayer's present method of accounting estimates inventory shrinkage. A taxpayer requesting such a change must file a Form 3115, Application for Change in Accounting Method, with the Commissioner in accordance with the requirements of §1.446-1(e)(3)(i) and Rev. Proc. 97-27, 1997-21 I.R.B. 10.

SECTION 4. RETAIL SAFE HARBOR METHOD

.01 The retail safe harbor method of estimating inventory shrinkage, as described in sections 4.02 through 4.07 of this revenue procedure, may be used in computing ending store inventory by taxpayers that are primarily engaged in retail trade (the resale of personal property to the general public), where physical inventories are normally taken at each location at least annually.

.02 The retail safe harbor method uses a historical ratio of shrinkage to sales to estimate the inventory shrinkage that occurred between the date of the last physical inventory and the end of the taxable year. This historical ratio is based on the actual shrinkage established by all physical inventories taken during the most recent three taxable years and the sales for related periods. The most recent three taxable years include the taxable year for which the shrinkage estimate is to be made and the two prior taxable years. The historical ratio, or estimated shrinkage determined using the historical ratio, cannot be adjusted by judgmental or other factors (for example, floors or caps).

.03 For stores with departments, a taxpayer must determine the historical ratio separately for each store or each department in a store. This determination must be done in the same manner for all stores with departments that are in the same trade or business of the taxpayer. For stores without departments, a taxpayer must determine the historical ratio separately for each store. If a taxpayer has a new store (or a new department in a store) for which the taxpayer has not verified shrinkage by a physical inventory in each of the most recent three taxable years, the historical ratio is the average of the historical ratios of the taxpayer's other stores (or other departments in the store where the taxpayer computes the historical ratio on a department basis) during the most recent three taxable years.

.04 The estimated inventory shrinkage permitted by the retail safe harbor method is determined by multiplying the historical ratio for each store or each department in a store by its sales for the period between the date of the last physical inventory and the end of the taxable year.

.05 Taxpayers using the last-in first-out (LIFO) inventory method must allocate shrinkage among their various LIFO inventory pools in a reasonable and consistent manner.

.06 Estimated shrinkage determined in accordance with consistent application of the retail safe harbor method may not be recalculated, through a look-back adjustment or otherwise, to reflect the results of physical inventories taken after year-end.

.07 A taxpayer that changes to the retail safe harbor method must use the retail safe harbor method consistently to determine the ending inventory for all stores that comprise a separate trade or business of the taxpayer. Use of the retail safe harbor method for estimating inventory shrinkage results in the clear reflection of income, provided this method is used consistently and the taxpayer's inventory methods otherwise satisfy the clear reflection of income standard.

SECTION 5. CHANGING TO THE RETAIL SAFE HARBOR METHOD OR OTHER METHOD OF ESTIMATING INVENTORY SHRINKAGE

.01 In general. Any change in a taxpayer's computation of ending inventory to estimate inventory shrinkage, or any change in the computation of such estimate, is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply.

.02 Automatic change. A taxpayer within the scope of this revenue procedure that wants to change to a method of accounting for estimating inventory shrinkage in computing ending inventory must follow the automatic change in accounting method provisions of Rev. Proc. 97-37, with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 97-37, as well as the application procedures in sections 6.03, 6.04, and 6.05 of Rev. Proc. 97-37, do not apply. However, if the taxpayer is under examination, before an appeals office, or before a federal court with respect to any income tax issue, the taxpayer must provide a copy of the Form 3115 to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

(2) A taxpayer that, on or before June 12, 1998, files its

original federal income tax return for its first taxable year ending on or after August 5, 1997, is not subject to the filing requirement in section 6.02(2)(a) of Rev. Proc. 97-37, provided the taxpayer complies with the following filing requirement. The taxpayer must complete and file a Form 3115 in duplicate. The original must be attached to the taxpayer's amended federal income tax return for the taxpayer's first taxable year ending on or after August 5, 1997. This amended return must be filed no later than August 11, 1998. A copy of the Form 3115 must be filed with the national office (see section 6.02(6) of Rev. Proc. 97-37 for the address) no later than when the taxpayer's amended return is filed.

(3) A taxpayer, whose present method of accounting estimates inventory shrinkage, does not receive audit protection under section 7 of Rev. Proc. 97-37 in connection with a change to the retail safe harbor method if, on the date the taxpayer files a copy of the Form 3115 with the national office, the taxpayer's present method of estimating inventory shrinkage is an issue under consideration within the meaning of section 3.09 of Rev. Proc. 97-37.

(4) In addition to all the requirements and procedures in Rev. Proc. 97-37, as modified by this revenue procedure, the following rules apply to a taxpayer within the scope of this revenue procedure that changes to a method other than the retail safe harbor method of accounting for estimating inventory shrinkage. The taxpayer must provide a detailed description of all aspects of the new method of estimating inventory shrinkage (including, for LIFO taxpayers, the method of determining inventory shrinkage for, or allocating inventory

shrinkage to, each LIFO pool) in the Form 3115 filed by the taxpayer for such a change. The District Director or national office subsequently may review whether the new method clearly reflects the taxpayer's income under § 446(b). If the District Director or the national office determines that the new method of accounting does not clearly reflect the taxpayer's income, the taxpayer will be treated as having made a change in method of accounting without obtaining the consent of the Commissioner as required by § 446(e). See section 6.06 of Rev. Proc. 97-37.

(5) For a change in method of accounting within the scope of this revenue procedure, the provisions of Rev. Proc. 97-37 are effective for taxable years ending after August 5, 1997.

(6) The transition rules in section 13.02 of Rev. Proc. 97-37 do not apply to any change in method of accounting within the scope of this revenue procedure. The Service will return any Form 3115 if it is filed with the national office pursuant to the Code, regulations, or administrative guidance other than Rev. Proc. 97-37 and the change in method of accounting is within the scope of this revenue procedure.

.03 Future change. A taxpayer that changes to the retail safe harbor method described in this revenue procedure will not be precluded, solely by reason of such change, from changing to another safe harbor method for estimating inventory shrinkage in computing ending inventory in the first year that such other safe harbor method is available.

SECTION 6. REGULATIONS AND REQUEST FOR PUBLIC COMMENT

The Service intends to issue regulations under § 471 regarding proper methods for estimating inventory shrinkage in computing ending inventory for taxable years ending after August 5, 1997. Comments are requested regarding safe harbor methods for estimating inventory shrinkage (including the retail safe harbor method), and any other issues that these regulations should address. Written comments should be submitted by August 11, 1998, to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044, Attn: CC:DOM:CORP:R (IT&A BRANCH 7, Room 5226). Submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to: Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington DC, Attn: CC:DOM:CORP:R (IT&A Branch 7, Room 5226). Alternatively, taxpayers may submit comments electronically at

http://www.irs.ustreas.gov/prod/tax_regs/comments.html

(the Service's internet site). All comments submitted will be available for public inspection and copying.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending after August 5, 1997.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 97-37 is modified and amplified to include this automatic accounting method change in the Appendix.

DRAFTING INFORMATION

The principal author of this revenue procedure is Jan L. Skelton of the Office of Assistant Chief Counsel (Income Tax and Accounting).

For further information regarding this revenue procedure, contact Ms. Skelton at (202) 622-4970 (not a toll-free call).