INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-133012-01/CC:ITA:B6

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

a =

b =

month 1 =

month 2 =

Date 1 =

Date 2 =

Year 1 =

ISSUE(S):

1. Can an examining agent change Taxpayer's method of determining the current-year cost of items making up its inventory pool under the last-in, first-out (LIFO) method of accounting when Taxpayer received the Commissioner's consent to use the "earliest acquisition" method but instead used a "dual index" method?

2. Should the National Office revoke a letter ruling that granted Taxpayer permission to select month 1 as an appropriate representative month for purposes of the Inventory Price Index Computation (IPIC) method under Treas. Reg. § 1.472-8(e)(3), and if the National Office revokes its letter ruling, what month would be most appropriate to Taxpayer's method of determining current-year cost?

3. Should Taxpayer be granted relief under § 7805(b) of the Internal Revenue Code if the National Office revokes the letter ruling that granted it permission to select month 1 as an appropriate representative month?

4. Is Taxpayer permitted to use a dual index method to determine the current-year cost of items making up its inventory pool when it uses the IPIC method?

CONCLUSION:

1. An examining agent can change Taxpayer's method of determining the current-year cost of items making up its inventory pool under the LIFO method of accounting when Taxpayer received the Commissioner's consent to use the "earliest acquisition" method but instead used a "dual index" method.

2. The National Office will revoke the letter ruling that granted Taxpayer permission to select month 1 as an appropriate representative month for purposes of the IPIC method under Treas. Reg. § 1.472-8(e)(3) because the Examination Division has indicated that it will change Taxpayer's method of determining current-year cost from the earliest acquisition method to the most recent purchases method. Under these circumstances, month 1 would not be an appropriate representative month. Moreover, since the Exam Division will change Taxpayer's method of determining current-year cost to the most recent purchases method, the most appropriate month will be one near the end of Taxpayer's taxable year.

3. Taxpayer is granted § 7805(b) relief. Accordingly, the revocation of the letter ruling will not be applied to tax years beginning prior to the date that Taxpayer is notified of the revocation.

4. In light of the resolution of issues No. 1 through 3, this issue is moot and will not be addressed.

FACTS:

Taxpayer is a national distributor of a and b and maintains its books and records on a first-in, first-out (FIFO) basis. Prior to its tax year beginning Date 1, Taxpayer valued its inventories using the dollar-value, link-chain, LIFO method and determined the current-year cost of its inventory using the most recent purchases method provided by Treas. Reg. § 1.472-8(e)(2)(ii)(a). Under this method, Taxpayer determined the total current-year cost of items making up its inventory pool by reference to the actual cost of goods most recently purchased or produced.

In Year 1, Taxpayer filed a Form 3115, Application for Change in Accounting Method, and requested the Commissioner's consent to change its LIFO method of accounting from the dollar-value, link-chain, method to the IPIC method. Taxpayer also requested the Commissioner's consent to change its method of determining current-year cost from the most recent purchases method to the earliest acquisition method. In connection with this proposed change, Taxpayer selected month 1 (the first month of its fiscal year) as an appropriate representative month for selecting indexes. Moreover, Taxpayer's Form 3115 indicated that it was not requesting any other change in method for its LIFO inventory.

On Date 2, the National Office issued a letter ruling to Taxpayer that granted its proposed change in method for its tax year beginning Date 1. In doing so, the letter ruling specifically provided that "[Taxpayer] will use the month of [month 1] as the appropriate representative month for selecting indexes to be used in determining the current-year cost of the inventory pool." (Emphasis added). The ruling letter also provided that "Whether the selection of the Producer Price Indexes to be used to compute an inventory price index is appropriate and the computations incidental to the use of such indexes are proper, will be determined in connection with the examination of [taxpayer's] . . . federal income tax return."

For tax years beginning after Date 1, Taxpayer did not track the actual cost of its purchases in the order of acquisition in accordance with the earliest acquisition method provided by Treas. Reg. § 1.472-8(e)(ii)(b), but instead used a dual index method. Under this dual index method, Taxpayer continues to determine the current-year cost of its ending inventory by reference to the actual cost of its most recent purchases. Taxpayer then uses an end-of-year index (the current-year deflator index) that it computes from the Producer Price Index Detailed Report to measure the inflation that had occurred during the current year. Next, Taxpayer uses this current-year deflator index to compute a current-year cumulative deflator index by multiplying the current-year deflator index by the cumulative deflator index from the prior year. Taxpayer uses this computed cumulative deflator index to deflate its ending inventory stated at current-year costs to base-year costs to determine whether an increment in its inventory has occurred. An increment in Taxpayer's inventory occurs when its ending inventory stated at base-year cost is greater than its beginning inventory stated at base-year cost.

When Taxpayer experiences an increment in its inventory, it computes the LIFO value of the increment by multiplying the increment stated at base-year cost by an "inflator index". The inflator index that Taxpayer uses to value an increment is different from the index that it uses to deflate its ending inventory. Taxpayer computes the deflator index by multiplying the inflation for the one month period from month 2 of the prior tax year to month 1 of the current year by the prior year's cumulative deflator index.

Upon examination of Taxpayer's return, the Examination Division determined that Taxpayer had failed to implement the change in method of accounting that was granted in the Date 2 letter ruling. Moreover, the Examination Division has determined that Taxpayer's selection of month 1 as a representative month was not appropriate. Therefore, the industry director has submitted this Request for Technical Advice asking the National Office whether it may change Taxpayer's method of determining current-year cost from a dual index method to the most recent purchases method and whether the letter ruling should be retroactively revoked to the extent it granted Taxpayer permission to elect month 1 as an appropriate representative month.

LAW AND ANALYSIS:

Issue 1. Can an examining agent change Taxpayer's method of determining the current-year cost of items making up its inventory pool under the LIFO method of accounting when Taxpayer received the Commissioner's consent to use the "earliest acquisition" method but instead used a "dual index" method?

As discussed below, Taxpayer's change in method of determining current-year cost was not in accordance with the letter ruling issued to it on Date 2. The Date 2 letter ruling granted Taxpayer permission to use the earliest acquisition method to determine the current-year cost of the items making up its inventory pool for tax years beginning after Date 1. For its tax years beginning after Date 1, Taxpayer did not use the earliest acquisition method, but instead used a dual index method. Therefore, Taxpayer's change in method was unauthorized and an examining agent can change Taxpayer back to its original method of determining current-year cost, the most recent purchases method. See sections 2.06 and 5.02 of Rev. Proc. 2002-18, 2002-13 I.R.B. 678.

Section 446(e) of the Code provides that, except as otherwise expressly provided, a taxpayer who changes the method of accounting on which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Commissioner. See also Treas. Reg. § 1.446-1(e)(2)(i). This consent requirement is necessary so as to allow the Commissioner time to review the proposed change in method to make certain that the change is to a correct method, that no tax abuse will result from the change, and that the change will be made with appropriate adjustments to ensure that no items of income escape taxation and that no items of expense are deducted twice. The consent requirement also enables the Commissioner to review changes for the protection of the public treasury, to assure taxpayer compliance with the requirement that the method used clearly reflects income, and otherwise to monitor taxpayer conduct. This consent requirement generally applies regardless of whether the taxpayer has a legitimate reason for the change or the correctness of the new method. See Wright Contracting Company v. Commissioner, 316 F.2d 249 (5th Cir. 1963). Moreover, when a taxpayer changes its method of accounting without first obtaining the Commissioner's consent, the Commissioner generally may require the taxpayer to change back to its original method of accounting. This rule has been applied even where the change is from an erroneous method to a correct method. See American Can Co. v. Commissioner, 317 F.2d 604 (2d. Cir. 1963); Commissioner v. O Liquidating Corp., 292 F.2d 225 (3rd Cir. 1961). Simply stated, the Commissioner may require that the change to the correct method be made in the appropriate manner using the appropriate procedures.

Taxpayer contends that it is evident from both the precise language of its Form 3115 and the letter ruling issued by the National Office that it received the Commissioner's consent to use a dual index method. Taxpayer also contends that although neither the letter ruling nor the Form 3115 explicitly disclosed that it was going to use dual indexes, persons familiar with the dollar-value LIFO method would have understood this. With regard to its contentions, Taxpayer argues that the National Office must have been aware that it was proposing to use "dual indexes" because under both the IPIC method and the link-chain method, price indexes are used for two separate and distinct purposes: first, to determine whether the inventory has experienced a quantitative change (i.e., whether an increment or decrement has resulted); and, second, to inflate any resulting increment stated at base-year cost to current-year costs. Taxpayer further argues that its Form 3115 fully disclosed that it was going to continue to use an end-of-the-year (most recent purchases) method and index to determine whether its inventory had experienced a quantitative change because its Form 3115 only indicated that it was going to change its "method used to figure the cost of goods in the closing inventory over those in the opening inventory" (i.e., the method used to determine the current-year cost of an increment). Moreover, Taxpayer argues that if its Form 3115 was ambiguous the National Office should have requested additional information.

For the following reasons, we are not persuaded by Taxpayer's arguments that it adopted the method to which the Commissioner consented.

First, Taxpayer's Form 3115 indicated that it was going to use the earliest acquisition method but made no reference to its use of dual indexes. Furthermore, Taxpayer's Form 3115 did not clearly indicate that it was going to continue to use a most recent purchases method to determine quantitative changes in its inventory.

Contrary to Taxpayer's arguments, a dual index method is not the earliest acquisition method described in the regulations. Section 1.472-8(e)(2)(ii)(b) of the Treasury Regulations provides that a taxpayer may determine the total current-year cost of items making up a pool by reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition. Under its dual index method, Taxpayer continues to use the most recent purchases method to determine the current-year cost of the items making up its inventory for purposes of determining whether a quantitative change has occurred in its inventory. Then, when its inventory experiences an increment, Taxpayer determines the current-year cost or value of the increment using a price index that is intended to approximate the results that may be derived from the use of the earliest acquisition method. In other words, Taxpayer's dual index method does not determine the current-year cost of the items making up its pool by reference to the actual cost of the goods purchased during the year in order of acquisition. Therefore, Taxpayer's dual index method is not the earliest acquisition method that is described in Treas. Reg. § 1.472-8(e)(2)(ii)(b).[1] See Mountain State Ford v. Commissioner, 112 T.C. 58 (1999). Moreover, since Taxpayer's dual index method is not the earliest acquisition method contemplated by the regulations, the National Office would not have understood that Taxpayer had requested to use a dual index method.

Second, Taxpayer's argument concerning the precise language of the Form 3115 is unpersuasive in that forms and instructions are not authoritative.[2] Therefore,

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[1]Taxpayer has also cited numerous technical advice memoranda for the proposition that a dual index method is not per se prohibited. See for example PLR 9853003, PLR 9444002, PLR 8749005, and PLR 8437004. Taxpayer's reliance on these memoranda is misplaced.

First, all of the cited memoranda clearly state that they should not be used or cited as precedent. See § 6110(k)(3). Second, although the memoranda do seem to indicate that a dual index method may be proper if its use results in a clear reflection of income, this sort of statement without further explanation is self evident. As a general rule, a method of accounting is proper if it clearly reflects a taxpayer's income. Therefore, the propriety of a dual index method generally was not the issue in any of these memoranda. Instead, these memoranda really addressed whether a specific taxpayer's dual-index method clearly reflected that taxpayer's income and any statement in those memoranda concerning the propriety of a dual-index method generally was merely dicta. Moreover, in each of the memoranda, the Service decided that the taxpayer's dual index method did not clearly reflect income. In any event, none of the memoranda provide any guidance as to when and under what circumstances a dual index method would clearly reflect a taxpayer's income. Lastly, none of the cited memoranda indicates that a dual index method is the earliest acquisition method that is provided by the regulations. Taxpayer received consent to use the earliest acquisition method and not some other proper method. Therefore, any argument regarding the propriety of a dual index method is irrelevant.

[2]Generally, forms and instructions do not bind the Service and are not intended to replace the law or change its meaning. The sources of authoritative law in the tax field are the statutes and regulations and not the informal publications and tax forms that are published by the Service. See Dixon v. United States, 381 U.S. 68, 73 (1965); Adler v. Commissioner, 330 F.2d 91, 93 (9th Cir. 1964), affg. T.C. Memo. 1963-196; Zimmerman v. Commissioner, 71 T.C. 367, 371 (1978), affd. without published opinion 614 F.2d 1294 (2d Cir. 1979); Green v. Commissioner, 59 T.C. 456, 458 (1972).

Taxpayer was not entitled to distill the tax law from the language of the Form 3115. Moreover, a careful reading of the regulation section that provides the methods to determine current-year cost when a taxpayer uses the dollar-value LIFO method to value its inventory reveals that the language of the Form 3115 is not fully consistent with the language contained in
§ 1.472-8.

The language contained on the Form 3115 tracks the language contained in § 1.472-2(d). This regulation section applies to a taxpayer that values its LIFO inventory using a unit method. In contrast, Treas. Reg. § 1.472-8(e)(2) is the relevant regulation section when a taxpayer values its LIFO inventory using the dollar-value method. The language of this regulation is slightly different than that provided by Treas. Reg. § 1.472-2(d) and provides that a taxpayer may determine the total current-year cost of items making up a pool using either the most recent purchases method, the earliest acquisition method, an average unit cost method, or any other proper method. See Treas. Reg. § 1.472-8(d)(2).

When the National Office issued its letter ruling, it was aware of the different language contained in each regulation section. Therefore, the National Office likely would have assumed that, since Taxpayer accounts for inventories under the dollar-value LIFO method, it was requesting to change its method of determining current-year cost for the items making up its pool and not only its method for purposes of valuing an increment.

Finally, Taxpayer's argument concerning the National Office's duty to seek additional information is not consistent with precedent. When a taxpayer files a Form 3115 requesting the Commissioner's consent to a change in method of accounting, the taxpayer has "a duty to reveal all material factors pertinent to its request for an accounting method change." Cochran Hatchery, Inc. v. Commissioner, T.C. Memo. 1979-390. Taxpayers cannot shift this burden to the National Office. See id.

In Cochran Hatchery, Inc. v. Commissioner, supra, a taxpayer was granted permission to change from an accrual method of accounting to the cash receipts and disbursements method of accounting (cash method). In requesting the change, the taxpayer fully and honestly provided all of the information requested on the Form 3115, but failed to disclose that most of the its sales were to a related party. In part, the Service granted the requested change on the taxpayer's representation that there was a long delay between the time of the sale and the receipt of payments on accounts receivable. Subsequently, the Service discovered that most of the taxpayer's sales were to a related party and, therefore, retroactively revoked the letter ruling. The taxpayer argued that the Service's revocation was an abuse of discretion.

Therefore, taxpayers who rely solely on IRS forms and instructions are at risk.

The Tax Court disagreed with the taxpayer and instead held that the revocation was justified. In doing so, the court reasoned that "[i]t would be exceedingly difficult, if not impossible, for [the Commissioner] to design specific questions covering every conceivable circumstance relating to an accounting method change." See id.

Similarly, although Taxpayer may have attempted to fully and honestly provide all the information requested on the Form 3115, the form still lacked certain information. In other words, the Form 3115 did not clearly disclose that Taxpayer was going to use dual indexes. Furthermore, as explained above, the National Office did not understand from Taxpayer's Form 3115 that it was only requesting to change its method of determining current-year cost for purposes of determining the value of a resulting increment and not for purposes of determining whether a quantitative change occurred.

Taxpayer's Form 3115 was unclear regarding its proposed change, and if an ambiguity existed with regard to Taxpayer's proposed change, Taxpayer, and not the National Office, had the duty to rectify the ambiguity. As explained in Cochran Hatchery, the taxpayer bears the burden of completing a Form 3115 so as to accurately notify the National Office of a requested change in method of accounting.

Issue 2. Should the National Office revoke a ruling letter that granted Taxpayer permission to select month 1 as an appropriate representative month for purposes of the IPIC method under Treas. Reg. § 1.472-8(e)(3), and if the National Office revokes its ruling letter what month would be most appropriate to Taxpayer's method of determining current-year cost?

A taxpayer using the IPIC method that does not use the retail inventory method must select indexes as of the month or months most appropriate to the taxpayer's method of determining the current-year cost of the inventory pool under Treas. Reg. § 1.472-8(e)(2)(ii) or make a one-time binding election of an appropriate representative month during the taxable year. See Treas. Reg. § 1.472-8(e)(3)(iii)(C). For this purpose, an appropriate representative month must be a month that has a nexus, or a relationship, to the taxpayer's method of determining current-year cost and its historical experience of inventory purchases during the year. See Rev. Rul. 89-29, 1989-1 C.B. 168.

In this case, Taxpayer did not implement the method for which consent was granted in the letter ruling. Therefore, Taxpayer changed its method of accounting without consent, and the Examination Division may change Taxpayer back to its old method, the most recent purchases method. When a taxpayer uses the most recent purchases method to determine its current-year cost, an appropriate representative month is almost invariably a month that is near the end of the year (assuming uniform purchases during the year). See id.

The letter ruling issued to Taxpayer provides that it may use month 1 (the first month in its fiscal year) as an appropriate representative month. However, the letter ruling also assumed that Taxpayer would use the earliest acquisition method to determine current-year cost. This assumption was an error.

Written permission to a taxpayer by the National Office consenting to a change in his accounting method is a "ruling." See section 601.204(c) of the Procedural and Administrative Regulations. When a ruling is found to be in error or not in accord with the current views of the Service, a ruling may be modified or revoked. See section 601.201(1)(4) of the Procedural and Administrative Regulations. See also section 12.04 of Rev. Proc. 2001-1, 2001 I.R.B. 1.

When Taxpayer was granted consent to use month 1 as an appropriate representative month, the National Office must have assumed that Taxpayer would use the earliest acquisition method to determine the current-year cost for purposes of determining not only the value of an increment, but also whether a quantitative change had occurred in its inventory pool. Since this assumption was an error, the letter ruling is hereby revoked to the extent it provided Taxpayer with consent to use the earliest acquisition method and use month 1 as an appropriate representative month. Furthermore, since Taxpayer is required to select indexes as of the month or months most appropriate to its method of determining current-year cost and the Examination Division has indicated that it will change Taxpayer's method from a dual-index method to the most recent purchases method, the month or months most appropriate is invariably a month towards the end of Taxpayer's taxable year.

Issue 3. Should Taxpayer be granted relief under § 7805(b) if the National Office revokes the letter ruling that granted it permission to select month 1 as an appropriate representative month?

A letter ruling granting consent to a change in accounting method is a letter ruling. A letter ruling found to be in error or not in accord with the current views of the Service may be revoked or modified. See section 601.204(c) of the Procedural and Administrative regulations; see also section 12.04 of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, 46. When a letter ruling is revoked, the revocation applies to all years open under the statute of limitations unless the Service exercises its discretionary authority under § 7805(b) to limit the retroactive effect of the revocation. See id. However, section 601.201(l)(5) of the Procedural and Administrative Regulations provides, in part, that except in rare and unusual circumstances, the revocation or modification of a ruling will not be applied retroactively with respect to the taxpayer to whom the ruling originally was issued or to a taxpayer whose tax liability directly was involved in such ruling if (i) there has been no misstatement or omission of material facts, (ii) the facts subsequently developed are not materially different from the facts on which the ruling was based, (iii) there has been no change in the applicable law, (iv) the ruling originally was issued with respect to a prospective or proposed transaction, and (v) the taxpayer directly involved in the ruling acted in good faith in reliance upon the ruling and the retroactive revocation would be to his detriment. See also section 12.05 of Rev. Proc. 2003-1. Failure to satisfy any one of the conditions contained in that section justifies the denial of relief.

In this case, although Taxpayer's change to IPIC is not itself adversely affected by the issuance of final regulations, these regulations do not allow taxpayers using IPIC to use dual indexes with two appropriate months for selecting such indexes, for taxable years ending on or after December 31, 2002.[3] See Treas. Reg. § 1.472-8(e)(3), as amended in Treas. Dec. 8976, 67 F.R. 1075 (2002). Treas. Dec. 8976, 67 F.R. 1075 (2002), was issued in part to clarify whether taxpayers using the IPIC method could use dual indexes in computing their current-year cost of LIFO inventory. The changes to the IPIC regulations, notably § 1.472-8(e)(3), as amended specifically state that "using one IPI (inventory price index) to compute the base-year cost of a dollar-value pool for the current taxable year and using a different IPI to compute the LIFO inventory value of the current taxable year's layer is not permitted under the IPIC method."

In applying § 7805(b) and section 10.02 of Rev. Proc. 97-27, when a taxpayer asks the National Office to consider the non-retroactive application of a revocation of any ruling, each case is considered on its individual merits. In this case, Taxpayer received a letter ruling from the National Office that permitted it to change to the earliest acquisition method and to use month 1 as an appropriate representative month. Taxpayer relied on the ruling letter when it changed its accounting method for its year beginning Date 1. Because there is sufficient question regarding the meaning of the information that Taxpayer provided the National Office in its Form 3115, we believe that §- 7805(b) relief is appropriate. Accordingly, the revocation of the letter ruling will not be applied until the earlier of the first tax year beginning after the date that Taxpayer is notified of the revocation or the first tax year to which the amendments to § 1.472-8(e)(3), effective December 31, 2001, apply to Taxpayer. The effect is to permit Taxpayer to use the method of accounting it implemented pursuant to its interpretation of the letter ruling until the above-stated taxable year.

Issue 4. Is Taxpayer permitted to use a dual index method to determine the current-year cost of items making up its inventory pool when it uses the IPIC method?

In light of the resolution of issues No. 1 through 3, this issue is moot and will not be addressed.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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[3] The amendments to § 1.472-8(e)(3) apply to taxable years ending on or after December 31, 2001. Amended § 1.472-8(e)(3)(v)(A). The preamble to T.D. 8976 also declared obsolete, effective January 9, 2002, Rev. Proc. 84-57, Rev. Rul. 89-29, and Rev. Proc. 98-49. Under the regulations, Taxpayer is granted automatic consent to change its method to a method permitted by the new regulations in either its first or second year ending on or after December 31, 2001. Section 1.472-8(e)(3)(v)(B).