INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference: March 16, 2007

LEGEND:

Member 1 =
Member 2 =
Member 3 =
Member 4 =
Member 5 =
Member 6 =
Member 7 =
Description of Business =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Input =

<u>Input Type 1</u> =
<u>Input Type 2</u> =
<u>Input Type 3</u> =
<u>Input Type 4</u> =
<u>Pool Type 1</u> =
<u>Pool Type 2</u> =
<u>Pool Type 3</u> =
<u>Pool Type 1 (Product 1)</u> =
<u>Pool Type 1 (Product 2)</u> =
<u>Pool Type 1 (Product 3)</u> =
<u>Pool Type 1 (Product 4)</u> =
<u>Pool Type 1 (Product 5)</u> =
<u>Pool Type 1 (Product 6)</u> =
<u>Pool Type 1 (Product 7)</u> =
<u>Pool Type 1 (Product 8)</u> =
<u>Pool Type 2 (Product 1)</u> =
<u>Pool Type 2 (Product 2)</u> =
<u>Pool Type 2 (Product 3)</u> =
<u>Pool Type 2 (Product 4)</u> =
<u>Pool Type 2 (Product 5)</u> =
<u>Pool Type 3 (Product 1)</u> =
<u>Pool Type 3 (Product 2)</u> =
<u>Pool Type 3 (Product 3)</u> =
<u>Pool Type 3 (Product 4)</u> =
<u>Pool Type 3 (Product 5)</u> =
<u>Product Input Form 1</u> =
<u>Product Input Form 2</u> =
<u>Product Input Form 3</u> =
<u>Product Input Form 4</u> =
<u>Product Input Form 5</u> =
<u>Product Group 1</u> =
<u>Location A</u> =
<u>Product Line 1</u> =
<u>Product Line 2</u> =
<u>Product Line 3</u> =
<u>Amount 1</u> =
<u>Amount 2</u> =
<u>Amount 3</u> =
<u>Product Line 1-1-1</u> =
<u>Product Line 1-1-2</u> =
<u>Product Line 1-1-3</u> =
<u>Product Line 1-1-4</u> =
<u>Product Line 1-1-5</u> =
<u>Product Line 1-1-6</u> =

Product Line 1-1-7 =
Product Line 1-1-8 =
Product Line 1-1-9 =
Product Line 1-1-10 =
Product Line 1-1-11 =
Product Line 1-1-12 =
Units =

ISSUE(S):

(1) Have the members of Taxpayer's consolidated group that use the dollar-value, last-in, first-out ("LIFO") method defined their inventory "items" too broadly to clearly reflect income?

(2) Have the members of Taxpayer's consolidated group that use the specific-goods LIFO method defined their inventory "product groups" too broadly to clearly reflect income?

CONCLUSION(S):

(1) Yes.

(2) Yes.

FACTS:

Taxpayer is the common parent of a consolidated group whose members operate Description of Business. Collectively, this consolidated group is one of the five largest businesses of its type in the United States. The members of Taxpayer's consolidated group acquire from primary producers Input Type 1; Input Type 2; Input Type 3; and Input Type 4 in Product Input Form 1; Product Input Form 2; Product Input Form 3; Product Input Form 4; Product Input Form 5, and other finished forms. Upon receiving an order from a customer, a member processes or distributes, or both, products made from the applicable Input to meet the customer's specifications. In general, the member changes only the shape or size, or both, of the product purchased from a primary producer. Though a member generally will not process Input until an order is received, it will process some standard-sized goods for quick turnaround. Thus, the majority of the goods in a member's inventories are classified as "raw materials."

In Year 1, Taxpayer elected the dollar-value LIFO inventory method. The following members of Taxpayer's consolidated group use the dollar-value LIFO method (year of election) to account for inventories: Member 1 (Year 3); Member 2 (Year 5); Member 3 (Year 5); Member 4 (Year 5); and Member 5 (Year 4). These members elected to pool their inventory items based on major line, type, or class of goods. Depending on the nature of its business, each member maintains from one to three dollar-value pools. Pool Type 1 generally will include Pool Type 1 (Product 1); Pool Type 1 (Product 2); Pool Type 1 (Product 3); Pool Type 1 (Product 4); Pool Type 1 (Product 5); Pool Type 1 (Product 6); Pool Type 1 (Product 7), and Pool Type 1 (Product 8). Pool Type 2 generally will include Pool Type 2 (Product 1); Pool Type 2 (Product 2); Pool Type 2 (Product 3); Pool Type 2 (Product 4); and Pool Type 2 (Product 5). Pool Type 3 generally will include Pool Type 3 (Product 1); Pool Type 3 (Product 2); Pool Type 3 (Product 3); Pool Type 3 (Product 4); and Pool Type 3 (Product 5).

The following members of Taxpayer's consolidated group use the specific-goods LIFO method (year of election) to account for inventories: Member 6 (Year 2); and Member 7 (Year 4). Member 6, which processes or distributes, or both, only Input Type 1, accounts for its inventories as a single class or type of goods. Member 7, which processes or distributes, or both, Input Type 1, Input Type 2, and Input Type 3, accounts for its inventories as three distinct classes or types of goods. Each member uses "Units" as the unit of measurement for each class or type of goods.

Submitted with the request for technical advice, Exhibit B contains data on the inventories of Member 1, which has inventories in several locations. Specifically, a schedule entitled "Recap LIFO Double Extension" provides summary data for 15 product groups at each location. In addition, a schedule entitled "Stock Status" lists the various types of goods (denoted by Member 1 as "product lines") that are summarized into those 15 product groups. Specifically, for each product line in Member 1's inventories, the second schedule shows: (1) Pieces on hand; (2) Quantity on hand in unit of measurement ("UM"); (3) Cost per UM; (4) Value; (5) Pieces available; and (6) Quantity available in UM. Though some names differ, it appears that each "product group" in Exhibit B has a corresponding "Pool Type (Product)."

Cost per UM varies among the product lines within a product group. For example, in Product Group 1 for Location A, Product Line 1 costs Amount 1 per UM; Product Line 2 costs Amount 2 per UM, and Product Line 3 costs Amount 3 per UM.

For book purposes, some members of Taxpayer's consolidated group maintain records for each stock keeping unit ("SKU"). Since Year 1, Taxpayer has been under continuous examination by the Examination Division of the Internal Revenue Service.

LAW AND ANALYSIS:

Section 446(a) of the Internal Revenue Code provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

Section 471(a) provides that whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall 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 the income.

Section 1.472-1(a) of the Income Tax Regulations provides that any taxpayer permitted or required to take inventories pursuant to the provisions of section 471, and pursuant to the provisions of §§ 1.471-1 to 1.471-9, inclusive, may elect with respect to those goods specified in his application and properly subject to inventory to compute his opening and closing inventories in accordance with the method provided by section 472, this section, and § 1.472-2. Under this last-in, first-out (LIFO) inventory method, the taxpayer is permitted to treat those goods remaining on hand at the close of the taxable year as being: (1) Those included in the opening inventory of the taxable year, in the order of acquisition and to the extent thereof, and (2) Those acquired during the taxable year. The LIFO inventory method is not dependent upon the character of the business in which the taxpayer is engaged, or upon the identity or want of identity through commingling of any of the goods on hand, and may be adopted by the taxpayer as of the close of any taxable year.

Section 1.472-1(c) provides that a manufacturer or processor who has adopted the LIFO inventory method as to a class of goods may elect to have such method apply to the raw materials only (including those included in goods in process and in finished goods) expressed in terms of appropriate units. If such method is adopted, the adjustments are confined to costs of the raw material in the inventory and the cost of the raw material in goods in process and in finished goods produced by such manufacturer or processor and reflected in the inventory.

Section 1.472-1(d) provides that for the purposes of this section, raw material in the opening inventory must be compared with similar raw material in the closing inventory. There may be several types of raw materials, depending upon the character, quality, or price, and each type of raw material in the opening inventory must be compared with a similar type in the closing inventory.

Section 1.472-1(e) provides that in the cotton textile industry there may be different raw materials depending upon marked differences in length of staple, in color or grade of the cotton. But where different staple lengths or grades of cotton are being used at different times in the same mill to produce the same class of goods, such differences would not necessarily require the classification into different raw materials.

Section 1.472-1(f) provides that as to the pork packing industry a live hog is considered as being composed of various raw materials, different cuts of a hog varying markedly in price and use. Generally a hog is processed into approximately 10 primal cuts and several miscellaneous articles. However, due to similarity in price and use, these may be grouped into fewer classifications, each group being classed as one raw material.

Section 1.472-2(c) provides that goods of the specified type included in the opening inventory of the taxable year for which the method is first used shall be considered as having been acquired at the same time and at a unit cost equal to the actual cost of the aggregate divided by the number of units on hand. The actual cost of the aggregate shall be determined pursuant to the inventory method employed by the taxpayer under the regulations applicable to the prior taxable year with the exception that restoration shall be made with respect to any writedown to market values resulting from the pricing of former inventories.

Section 1.472-2(d) provides that goods of the specified type on hand as of the close of the taxable year in excess of what were on hand as of the beginning of the taxable year shall be included in the closing inventory, regardless of identification with specific invoices and regardless of specific cost accounting records, at costs determined pursuant to the provisions of subparagraph (1) or (2) of this paragraph, dependent upon the character of the transactions in which the taxpayer is engaged: (1)(i) In the case of a taxpayer engaged in the purchase and sale of merchandise, such as a retail grocer or druggist, or engaged in the initial production of merchandise and its sale without processing, such as a miner selling his ore output without smelting or refining, such costs shall be determined--(a) By reference to the actual cost of the goods most recently purchased or produced; (b) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition; (c) By application of an average unit cost equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced, the goods reflected in such inventory increase being considered for the purposes of section 472 as having been acquired all at the same time; or (d) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income. (2) In the case of a taxpayer engaged in manufacturing, fabricating, processing, or otherwise producing merchandise, such costs shall be determined: (i) in the case of raw materials purchased or initially produced by the taxpayer, in the manner elected by the taxpayer under subparagraph (1) of this paragraph to the same extent as if the taxpayer were engaged in purchase and sale transactions; and (ii) in the case of goods in process, regardless of the stage to which the manufacture, fabricating, or processing may have advanced, and in the case of finished goods, pursuant to any proper method which, in the opinion of the Commissioner, clearly reflects income.

Section 1.472-8(a) provides that any taxpayer may elect to determine the cost of his LIFO inventories under the so-called "dollar-value" LIFO method, provided such method is used consistently and clearly reflects the income of the taxpayer in accordance with the rules of this section. The dollar-value method of valuing LIFO inventories is a method of determining cost by using "base-year" cost expressed in terms of total dollars rather than the quantity and price of specific goods as the unit of measurement. Under such method the goods contained in the inventory are grouped into a pool or pools as described in paragraphs (b) and (c) of this section. The term "base-year cost" is the aggregate of the cost (determined as of the beginning of the taxable year for which the LIFO method is first adopted, i.e., the base date) of all items in a pool. The taxable year for which the LIFO method is first adopted with respect to any item in the pool is the "base year" for that pool, except as provided in paragraph (g)(3) of this section. Liquidations and increments of items contained in the pool shall be reflected only in terms of a net liquidation or increment for the pool as a whole. Fluctuations may occur in quantities of various items within the pool, new items which properly fall within the pool may be added, and old items may disappear from the pool, all without necessarily effecting a change in the dollar value of the pool as a whole. An increment in the LIFO inventory occurs when the end of the year inventory for any pool expressed in terms of base-year cost is in excess of the beginning of the year inventory for that pool expressed in terms of base-year cost. In determining the inventory value for a pool, the increment, if any, is adjusted for changing unit costs or values by reference to a percentage, relative to base-year-cost, determined for the pool as a whole. See paragraph (e) of this section. See also paragraph (f) of this section for rules relating to the change to the dollar-value LIFO method from another LIFO method.

Section 1.472-8(b)(3)(i)(a) provides that a taxpayer may elect to establish multiple pools for inventory items which are not within a natural business unit as to which the taxpayer has adopted the natural business unit method of pooling as provided in subparagraph (1) of this paragraph. Each such pool shall ordinarily consist of a group of inventory items which are substantially similar. In determining whether such similarity exists, consideration shall be given to all the facts and circumstances. The formulation of detailed rules for selection of pools applicable to all taxpayers is not feasible. Important considerations to be taken into account include, for example, whether there is substantial similarity in the types of raw materials used or in the processing operations applied; whether the raw materials used are readily interchangeable; whether there is similarity in the use of the products; whether the groupings are consistently followed for purposes of internal accounting and management; and whether the groupings follow customary business practice in the taxpayer's industry. The selection of pools in each case must also take into consideration such factors as the nature of the inventory items subject to the dollar-value LIFO method and the significance of such items to the taxpayer's business operations. Where similar types of goods are inventoried in natural business units and multiple pools of the taxpayer, the Commissioner may apportion or allocate such goods among the natural business units and the multiple pools, if he determines that such apportionment or allocation is necessary in order to clearly reflect the income of the taxpayer.

Section 1.472-8(b)(3)(i)(b) provides that raw materials which are substantially similar shall be pooled together in accordance with the principles of this subparagraph. However, inventories of raw or unprocessed materials of an unlike nature may not be placed into one pool, even though such materials become part of otherwise identical finished products.

Section 1.472-8(b)(3)(i)(c) provides that finished goods and goods-in-process in the inventory shall be placed into pools classified by major classes or types of goods. The same class or type of finished goods and goods-in-process shall ordinarily be included in the same pool. Where the material content of a class of finished goods and goods-in-process included in a pool has been changed, for example, to conform with current trends in an industry, a separate pool of finished goods and goods-in-process will not ordinarily be required unless the change in material content results in a substantial change in the finished goods.

Section 1.472-8(d) provides that whether the number and the composition of the pools used by the taxpayer is appropriate, as well as the propriety of all computations incidental to the use of such pools, will be determined in connection with the examination of the taxpayer's income tax returns. Adequate records must be maintained to support the base-year unit cost as well as the current-year unit cost for all items priced on the dollar-value LIFO inventory method, regardless of the method authorized by § 1.472-8(e) which is used in computing the LIFO value of the dollar-value pool. The pool or pools selected must be used for the year of adoption and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change is granted by the Commissioner as provided in § 1.446-1(e). However, see § 1.472-8(h) for authorization to change the method of pooling in certain specified cases.

Issue (1): Have the members of Taxpayer's consolidated group that use the dollar-value LIFO method defined their inventory "items" too broadly to clearly reflect income?

Taxpayer argues that "item" should be defined broadly because of the nature of its inventories. Under Taxpayer's item-definition method, Pool Type 1 will continue to have only 8 items, including Pool Type 1 (Product 1). For example, in Location A, Member 1's Pool Type 1 (Product 1) includes the following "product lines": Product Line 1-1-1, Product Line 1-1-2, Product Line 1-1-3, Product Line 1-1-4, Product Line 1-1-5, Product Line 1-1-6, Product Line 1-1-7, Product Line 1-1-8, Product Line 1-1-9, Product Line 1-1-10, Product Line 1-1-11, and Product Line 1-1-12. In contrast, Exam argues that "item" should be defined as narrowly as each member's books and records will allow. Under Exam's item-definition method, each member will have one item for each SKU. In Exam's view, this is the only item-definition method that will prevent the member's LIFO indexes from including artificial inflation caused by changes in quality and product mix.

In our view, the members of Taxpayer's consolidated group have defined "item" too broadly to clearly reflect income because their definition compensates them for the effects of artificial inflation resulting from changes in quality and product mix. For example, the 12 product lines comprising Member 1's Pool Type 1 (Product 1) have significantly different uses and unit costs. Furthermore, it is not at all clear that the same cannot be said about the various products that comprise each of these product lines. *See* Exhibit B.

The purpose of the LIFO method is to permit a taxpayer to exclude the effects of inflation (*i.e.*, steadily rising cost of replacement goods) from its computation of gross income. But the LIFO method was not designed to compensate for the effects of artificial inflation, which can result from changes in quality and product mix. *See, e.g., Amity Leather Products Co. v. Commissioner*, 82 T.C. 726, 733 (1984). To minimize the effects of artificial inflation under the dollar-value LIFO method, the regulations require taxpayers to assign "items" to one or more dollar-value pools. Unfortunately, neither the Code nor the applicable regulations define "item," but the *Amity* Court opined that a narrower definition will provide a more accurate measure of inflation (*i.e.*, price index). The Court also opined, however, that the definition of "item" must be administratively feasible and not unduly burdensome from the standpoint of each of the parties (*i.e.*, the taxpayer and Exam). *Amity Leather supra*, at 734. Stated differently, the definition of "item" depends on the taxpayer's facts and circumstances. In our view, Exam's proposed definition will exclude the effects of artificial inflation from each member's LIFO indexes without imposing an unnecessary administrative burden on those members because they already maintain inventory data at the SKU level. *See, e.g., Richardson v. Commissioner*, T.C. Memo. 1996-368 (1996).

We note, however, that because the definition of "item" depends on the taxpayer's facts and circumstances, more than one item-definition method may clearly reflect income in a particular case. Thus, a taxpayer may combine two or more SKUs into a single "item" for LIFO purposes provided that: (1) all the SKUs combined into that item are essentially the same product; and (2) the characteristic(s) that distinguish one SKU from all the other SKUs combined into that item do not affect the unit cost of the goods assigned to those SKUs or to that item. For example, if a department store pays $20 for each Brand X all-cotton "Macho Man" dress shirt (regardless of the shirt's color, collar size, or sleeve length) and then assigns size 16-33 blue dress shirts to SKU #11, size 17-34 blue dress shirts to SKU #12, size 16-33 white dress shirts to SKU #21, and size 17-34 white dress shirts to SKU #22, the department store may combine all four SKUs into one item (*e.g.*, Item #1) because the differences in color, collar size, and sleeve length do not affect the unit cost of the shirts assigned to each of these SKUs or to Item #1. Thus, the department store's inflation index for "Macho Man" dress shirts will be the same regardless of changes in product mix. Stated differently, the department store's inflation index for "Macho Man" dress shirts will continue to move in the same direction and at the same rate regardless of whether the department store treats each SKU as a separate item or combines all four SKUs into one item. Similarly, if that department store pays $25 for each Brand X "Girlie Man" all-cotton dress shirt (regardless of the shirt's color, collar size, or sleeve length), the department store may combine all the related SKUs into one item (*e.g.*, Item #2). But the department store may not combine the "Macho Man" and the "Girlie Man" dress shirts into one item. Though both types of Brand X dress shirts are all-cotton, the cost of the cotton used in these dress shirts is only one of the factors that affects the prices set by the supplier of these shirts. Similarly, if a manufacturer of ice cream pays $100 for a 100-pound bar of dark chocolate and $50 for 50-pound bar of dark chocolate, the unit cost (*i.e.*, cost per pound of dark chocolate) paid for bars of dark chocolate should continue to move in the same direction. Thus, the manufacturer's inflation index will be the same regardless of whether the manufacturer treats 100-pound and 50-pound bars of dark chocolate as separate items or combines them into the same item.

Issue (2): Have the members of Taxpayer's consolidated group that use the specific-goods LIFO method defined their inventory "product groups" too broadly to clearly reflect income?

Taxpayer argues that "product group" should be defined broadly. Under Taxpayer's approach, its inventories of <u>Input Type 1</u> will continue to have only 8 product groups analogous to the items used by the members using dollar-value LIFO. Taxpayer contends that when Congress enacted the LIFO method in 1938 to benefit smelters, refiners, and producers of primary metals, Congress could not have intended for these taxpayers to account for inventories at the SKU level because computers and calculators, the tools needed to compute LIFO inventories at the SKU level, had not been invented. In addition, Taxpayer cites § 1.472-1(e) (concerning the cotton textile industry) and § 1.472-1(f) (concerning the pork-packing industry) for the proposition that not all "marked" differences in raw materials require a taxpayer to assign them to different product groups. Finally, Taxpayer contends that the price it pays for the goods assigned to a particular product group (*e.g.*, <u>Product Group 1</u>) depends primarily on the commodity prices of the materials used to produce those goods. Thus, Taxpayer believes that accounting for LIFO inventories in readily determinable units of measurement (*e.g.*, pounds, tons, feet, yards, gallons, barrels) is permissible.

In our view, the members of Taxpayer's consolidated group have defined "product group" too broadly to clearly reflect income because their definition compensates them for the effects of artificial inflation resulting from changes in quality and product mix. Under the specific-goods LIFO method, a product group functions as something akin to an item-pool. In other words, goods within a single product group must be similar, but need not be identical. But Taxpayer has not shown that the definition method used by each member of its consolidated group actually results in the assignment of inventoriable goods to product groups based on "character, quality, and price" as required by regulations. *See* § 1.472-1(d).

Furthermore, we are not persuaded that §§ 1.472-1(e) and (f) bolster Taxpayer's position. First, § 1.472-1(e) provides that "cotton" might have to be treated as more than one raw material depending upon marked differences in the length of staple, in color, or in grade, but also provides a potential exception when the various types of cotton are used interchangeably in the same mill to produce the same class of goods. Taxpayer has not shown that the various goods falling within each member's product group (*e.g.*, Product Group 1) are interchangeable, in the sense of § 1.472-1(e), with the other goods in that product group. Moreover, Taxpayer's argument concerning commodity prices applies equally to the wood products used by furniture manufacturers. For example, a reasonable furniture manufacturer will recognize that sheets of exterior-grade plywood, sheets of MDF, cherry boards, and cherry posts are not members of the same product group because these products do not share the same character, quality, and price. But, when defining "product groups," that furniture manufacturer may not end its analysis at this point ("first cut"). For example, the furniture manufacturer may not assign all cherry posts (*e.g.*, 2x2 posts, 4x4 posts, 6x6 posts) to a single product group. Though all cherry posts are made from the same input (*i.e.*, cherry wood), a 2x2 post generally is not interchangeable with a 6x6 post. Furthermore, a 2x2 post generally will cost less per board foot than a 6x6 post of the same grade of cherry. Regrettably, when defining their "product groups," the members of Taxpayer's consolidated group stopped at their equivalent of the first cut.

Second, § 1.472-1(f) provides that a live hog is considered to be composed of various raw materials, different cuts of a hog varying markedly in price and use. This regulation states that a hog is processed into 10 primal cuts and several miscellaneous cuts, but then provides that due to similarity in price and use, *these* may be grouped into fewer classifications, each group being classed as one raw material. Though the use of "these" in the preceding sentence creates ambiguity, the better reading of the sentence is that "these" refers to the "several miscellaneous cuts," which are more likely to have a "similar price and use" than the "different cuts," which the first sentence states "vary markedly" in price and use. Regardless, Taxpayer has not shown that the various goods falling within each member's product group are analogous in any way to the cuts of pork that come from a hog, especially those several miscellaneous cuts of pork that are similar in price and use.

Once again, however, we note that because the definition of "product group" depends on the taxpayer's facts and circumstances, more than one definition method may clearly reflect income in a particular case. Thus, each member of Taxpayer's consolidated group may be permitted to combine two or more SKUs into a single "product group" for LIFO purposes, provided that all the SKUs combined into that product group are similar in character, quality, and price. Whether a group of SKUs are similar in character, quality, and price is a factual issue. For example, in the case of our furniture manufacturer, 2x2 cherry posts of various lengths may be part of the same product group. In any event, "product group" is broad enough to include all the SKUs that may be combined into a single "item" under the dollar-value method.

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.