Office of Chief Counsel
Internal Revenue Service
Memorandum

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from: Jeffrey G. Mitchell
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(Income Tax & Accounting)

subject:

This Chief Counsel Advice responds to your request for assistance dated February 28, 2007. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Animal =

Date 1 =

x =

Period A =

Period B =

Period C =

Earliest Processing Age =

Average Processing Age =

ISSUES

Whether, under § 1.471-6(e) of the Income Tax Regulations, Taxpayer's unit-livestock-price (ULP) method classification of the Animals in its inventory with respect to their age reasonably accounts for the normal cost incurred in producing the animals within each class.

CONCLUSION

Taxpayer's classification of the Animals in its inventory with respect to their age does not reasonably account for the normal cost incurred in producing the animals within each class.

FACTS

Taxpayer is a vertically integrated producer, processor, marketer and distributor of fresh and processed Animal products. Taxpayer is also a producer of feed for its Animals.

For the taxable years at issue, Taxpayer, through some of its subsidiaries, used the ULP method allowed under § 1.471-6(e) to account for its field inventory of Animals. Under the ULP method, Taxpayer selected various age classifications and assigned a standard unit price to each class.

For the taxable year ended Date 1, Taxpayer used the following ULP age classifications and approximate standard unit prices for its Animals:

ULP Classification	Approximate ULP Standard Unit Price
Period A	10x
Period B	97x
Period C	238x

Thus, any Animal whose age falls within Period A is valued at 10x per head, while an Animal whose age falls within Period B is valued at 97x per head. Any Animal whose age falls within Period C is valued at 238x per head.

The length of Period A is more than three times the length of Period B. Some Animals are processed as early as Earliest Processing Age, which is approximately 63 percent of the way through Period A. The beginning of Period B represents the end of the growing cycle for a large percentage of Animals. The average age of Animals processed as of Date 1 was Average Processing Age, which is approximately 40 percent of the way through Period B. Period A represents approximately 89 percent of the total lifespan of an Animal processed at Average Processing Age. An Animal processed at Average Processing Age will be assigned a unit price representing approximately 9 percent of its final unit price until it reaches Period B, at which point it will be assigned the remaining approximately 91 percent of its final unit price.

The year-end breakdown for Taxpayer's taxable year ending on Date 1 was as follows:

ULP Classification	Approximate Percentage of Animals in Class at Year-End
Period A	43 percent
Period B	50 percent
Period C	7 percent

LAW AND ANALYSIS

Section 446(a) of the Internal Revenue Code provides: "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 446(b) provides: "If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."

Section 471 provides: "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 1.471-1 provides, in part: "In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor."

Section 1.471-6(c) provides, in part: "Because of the difficulty of ascertaining actual cost of livestock and other farm products, … farmers raising livestock may value their inventories of animals according to either the 'farm price method' or the 'unit-livestock-price method'."

Section 1.471-6(e) provides:

> The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: Calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the district director upon examination of the taxpayer's return.

Section 1.471-6(f) provides, in part:

> A taxpayer that elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. … Once established, the methods of accounting used by the taxpayer to determine unit prices and to classify animals must be consistently applied in all subsequent taxable years. A taxpayer that uses the unit-livestock-price method must annually reevaluate its unit prices and adjust the prices either upward to reflect increases, or downward to reflect decreases, in the costs of raising livestock. The consent of the Commissioner is not required to make such upward or downward adjustments. No other changes in the classification of animals or unit prices may be made without the consent of the Commissioner. See § 1.446-1(e) for procedures for obtaining the consent of the Commissioner.

It has been long understood that the ULP method is an imprecise method of allocating inventory costs. "It must be realized that the unit-livestock-price method is at best an approximation and it will rarely be equally desirable by both parties. However, it does serve a useful purpose in that it greatly eases the bookkeeping burden on many taxpayers without an inordinate sacrifice in accuracy." *Auburn Packing Co., Inc. v. Comm.*, 60 T.C. 794, 801 (1973).

Use of the ULP will generally result in at least some small degree of undercapitalization of costs. During the period between the beginning and end of an age classification, a taxpayer will typically be incurring costs in raising the animal; however, none of these costs will be capitalized until the animal reaches the next age classification. In the ULP example provided in § 1.471-6(e) described above, a newborn calf will be assigned a unit price of $15, and will retain that unit price until it reaches the next classification of yearling, at which point it will be assigned a unit price of $22.50. For any calf inventoried prior to its reaching yearling status, none of the costs incurred in raising the calf during its first year will have been capitalized. Such undercapitalization is inherent in the age classification system provided by the ULP method.

However, the issue is whether Taxpayer’s ULP method entails a “reasonable” classification of the animals so that the unit prices assigned to the several classes will “reasonably account for the normal cost incurred in producing the animals within such classes” as required by § 1.471-6(e). We believe that this requires a system in which the values assigned to each class increase at a fairly even, moderate inclination relative to the costs incurred in raising the Animal.

As discussed above, Period A represents 89 percent of the total lifespan of an Animal processed at Average Processing Age, and the length of Period A is also more than three times the length of Period B. An Animal processed at Average Processing Age will be assigned a unit price representing approximately 9 percent of its final unit price until it reaches Period B, at which point it will be assigned the remaining approximately 91 percent of its final unit price. In other words, Taxpayer’s ULP method assigns the same value to a day-old Animal as to an Animal that has nearly reached Average Processing Age, and then increase its assigned value overnight to an amount nearly ten times the previous value, despite the fact that feed and other costs are incurred continuously throughout the Animal’s life.

The regulations under § 1.471-6 relating to the ULP method do not specify the appropriate length of time to be used for each age class of an animal, and we do not believe that there is a single correct set of ULP age classifications that must be used by Taxpayer to value its Animals. However, we believe the ULP age classifications and corresponding values used in this case by Taxpayer, for the reasons discussed above, do not at all increase at a fairly even, moderate inclination relative to the costs incurred. Consequently, Taxpayer’s classification of the Animals in its inventory with respect to their age does not meet the requirement under § 1.471-6 to reasonably account for the normal cost incurred in producing the animals within each class, and thus does not clearly reflect income.

Since Taxpayer’s ULP method does not clearly reflect income, the Internal Revenue Service may require Taxpayer to use any method that in its opinion clearly reflects the taxpayer's taxable income.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call if you have any further questions.