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to: Associate Area Counsel (LMSB), Area 2, Detroit, Michigan

from: Associate Chief Counsel (Income Tax & Accounting)
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subject: Chief Counsel Advice on Combining Pools Under Rev. Proc. 2008-23

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

ISSUE:

How does a reseller of cars, light-duty trucks, and "crossover" vehicles (collectively, "vehicles") implement the change to the Vehicle-Pool Method sanctioned in Rev. Proc. 2008-23, 2008-12 I.R.B.?

LAW & ANALYSIS:

1. Law:

Section 472(a) of the Internal Revenue Code provides generally that a taxpayer may use the LIFO method of inventorying goods if, among other requirements, the change to, and use of, the method is in accordance with such regulations as the Secretary may prescribe as necessary in order that the use of the method may clearly reflect income.

Section 1.472-8(g)(1) of the Income Tax Regulations provides that any change in method of pooling authorized by § 1.472-8 and used in computing the taxpayer's LIFO inventories under the dollar-value LIFO method shall be treated as a change in method of accounting. Any method of pooling that is authorized by § 1.472-8 shall 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). If the taxpayer changes from one method of pooling to another method of pooling, the ending LIFO inventory for the taxable year preceding the year of change shall be restated under the new method of pooling.

Section 1.472-8(g)(2)(i) provides, in relevant part, that a taxpayer who has been using the dollar-value, LIFO method and who is permitted or required to change its method of pooling shall combine or separate the LIFO value of its inventory for the base year and each yearly layer of increment in order to conform to the new pool or pools. The combination or separation of the LIFO value of the taxpayer's inventory for the base year and each yearly layer of increment shall be made in accordance with the appropriate method in § 1.472-8(g)(2), unless the use of a different method is approved by the Commissioner. Section 1.472-8(g)(2)(iii) provide rules that a taxpayer must apply when combining pools with the same base year, and section 1.472-8(g)(2)(iv) provide rules that a taxpayer must apply when combining pools with different base years. In addition, sections 1.472-8(g)(2)(iii) and (iv) contain examples showing the application of these rules but only for taxpayers that use the "double-extension" method.

Section 4.01(2) of Rev. Proc. 2008-23 provides that a taxpayer changing to the New Vehicle Pool method must make the change on a cut-off basis (see section 2.06 of Rev. Proc. 2002-9) and must comply with § 1.472-8(g). Instead of using the earliest taxable year for which the reseller adopted the LIFO method for any items in a pool, the reseller must use the year of change as the base year when determining the LIFO value of that pool for the year of change and subsequent taxable years (*i.e.*, the cumulative index at the beginning of the year of change will be 1.00). The reseller must restate the base-year cost of all layers of increment in a pool at the beginning of the year of change in terms of new base-year cost. For an example of establishing a new base year, see § 1.472-8(e)(3)(iv)(B)(1)(ii).

2. Analysis:

When combining two or more pools that have the same base year, a taxpayer using the double-extension method sums the base-year cost and LIFO value of each layer of all pools to obtain the total base-year cost and total LIFO value, respectively, of the newly combined pool. In contrast, when combining pools having different base years, the taxpayer treats the base year of the oldest pool as the base year of the newly combined pool and treats all subsequent base years as increments. In addition, the taxpayer restates the base-year cost of all increments arising from each pool other than that oldest pool ("newer pool") in terms of the base-year cost of the base layer of that oldest pool. To restate a newer pool's base-year cost, a taxpayer using the double-extension method reconstructs or establishes a new base-year cost for each item in the newer pool. §§ 1.472-8(e)(2) and (g)(2)(iv).

Though § 1.472-8(g)(2) does not describe how a taxpayer using a link-chain method combines pools, we believe that analogous rules generally apply. Most of the principles, concepts, and operating rules that apply to the double-extension method also apply to the link-chain method. Furthermore, the regulations that sanction the double-extension method are cited frequently to justify various methods and approaches used with the link-chain method. *See, e.g.,* § 1.472-8(e)(2)(iv) (describing the rules for determining increments and decrements of LIFO layers). However, the rules prescribed in § 1.472-8(g)(2)(iv) (concerning how pools with different base years are to be combined) do not work when a taxpayer uses the link-chain method because under the link-chain method, the taxpayer determines the base-year cost of a pool using an annually determined cumulative (deflator) index rather than summing the base-year costs of each item in the pool. Thus, these rules must be adapted to the link-chain method. To restate a newer pool's base-year cost, a taxpayer using the link-chain method divides that pool's base-year cost by the oldest pool's cumulative index, computed as of the newer pool's base year. For example, if the oldest pool has a base year of 1997 and the newer pool has a base year of 2002, the taxpayer uses the oldest pool's 2002 cumulative index as the divisor. This restatement procedure, like the procedure for the double-extension method, generally treats the taxpayer as having included the items in the newer pool in the oldest pool beginning in the newer pool's base year.

A reseller must comply with § 1.472-8(g) when combining a New Car pool and a New Light-Duty Truck pool into a New Vehicle pool and when combining a Used Car pool and a Used Light-Duty Truck pool into a Used Vehicle pool. The following examples shows how a reseller that uses a link-chain method complies with § 1.472-8(g). The examples also illustrate the establishment of the year of change as the new base year for the newly combined pool. It is important to note that in both examples, the base-year cost of each LIFO layer is in the same proportion to the total base-year cost both before and after the establishment of the new base year. Though there may be other approaches to implementing the change to the Vehicle-Pool method, we have doubts about any approach that allocates the new base-year cost among LIFO layers in different proportions.

Example 1 (Same base year). Reseller is a franchised dealer of new cars, new light-duty trucks, and new crossover vehicles (including SUVs, vans, minivans and other similar vehicles) (collectively, "new vehicles"). Reseller uses a dollar-value, link-chain LIFO method to account for inventories of new vehicles. Assume that Reseller has a New Car pool and a New Light-Duty Truck pool (New Truck pool) at December 31, 2007, with the inventory data shown in Table 1 and Table 2, respectively, and that Reseller obtains automatic consent under Rev. Proc. 2008-23 to combine these pools into a New Vehicle pool for the taxable year ended December 31, 2008 (year of change).

Table 1 – New Car Pool			12/31/2007
Layer	Base Cost	Index	LIFO Value

2005 Base Layer	$10,000	1.0000	$10,000
2006 Layer	2,000	1.1000	2,200
2007 Layer	1,000	1.2000	1,200
Total	$13,000		$13,400

Table 2 – New Truck Pool   12/31/2007

Layer	Base Cost	Index	LIFO Value
2005 Base Layer	$5,000	1.0000	$5,000
2007 Layer	3,000	1.4000	4,200
Total	$8,000		$9,200

To implement the change in method of pooling for these new vehicles, Reseller first determines the current-year cost of the entire inventory. Assume that the current-year costs of Reseller's New Car pool and New Truck pool at December 31, 2007, are $15,600 and $11,200, respectively. Next, as shown in Table 3, Reseller combines the base costs of the two pools (year by year) to create base costs for the New Vehicle pool (year by year) and combines the LIFO values of the two pools (year by year) to create the LIFO values for the New Vehicle pool (year by year).

Table 3 Summary	New Car Pool	New Truck Pool	New Vehicle Pool
Current-Year Cost	$15,600	$11,200	$26,800
÷ Cumulative Index	1.2000	1.4000	
Base Cost	$13,000	$ 8,000	$21,000
Layers at Base Cost			
2005 Base Layer	$10,000	$5,000	$15,000
2006 Layer	2,000	0	2,000
2007 Layer	1,000	3,000	4,000
Total	$13,000	$8,000	$21,000
Layers at LIFO Value			
2005 Base Layer	$10,000	$5,000	$15,000
2006 Layer	2,200	0	2,200
2007 Layer	1,200	4,200	5,400
Total	$13,400	$9,200	$22,600

Next, as shown in Table 4, Reseller revises each of the layer indexes to reflect the relationship between base cost and LIFO value for the New Vehicle pool.

Table 4 – New Vehicle Pool Layer	Layers at Base Cost	Revised Index	12/31/2007 LIFO Value
2005 Base Layer	$15,000	1.0000	$15,000
2006 Layer	2,000	1.1000	2,200

2007 Layer	4,000	1.3500	5,400
Total	$21,000		$22,600

Next, Reseller restates the 2007 cumulative index of the New Vehicle pool as 1.2762 ($26,800 [current-year cost of New Vehicle pool] ÷ $21,000 [base cost of New Vehicle pool]). Then, Reseller restates the base year of the New Vehicle Pool to the current year. As shown in Table 5, Reseller multiplies the Layers at Base cost by the restated cumulative index of 1.2762.

Table 5 – Restated Layers	Layers at Base	Cumulative	Layers at Updated
Layers	Cost	Index	Base Cost
2005 Base Layer	$15,000	1.2762	$19,143
2006 Layer	2,000	1.2762	2,552
2007 Layer	4,000	1.2762	5,105
Total	$21,000		$26,800

Next, as shown in Table 6, Reseller revises each of the layer indexes to reflect the relationship between base cost and LIFO value for the New Vehicle pool.

Table 6 – New Vehicle Pool	Layers at Updated	Revised	12/31/2007
Layers	Base Cost	Index	LIFO Value
2005 Base Layer	$19,143	.7836	$15,000
2006 Layer	2,552	.8621	2,200
2007 Layer	5,105	1.0578	5,400
Total	$26,800		$22,600

Finally, Reseller restates the 2007 *cumulative* index of the New Vehicle pool as 1.0000 ($26,800 [current-year cost of New Vehicle pool] ÷ $26,800 [base cost of New Vehicle pool]).

Example 2 (Different base years). The facts are the same as *Example 1*, except that Table 1 and Table 2 provide the following data:

Table 1 – New Car Pool			12/31/2007
Layer	Base Cost	Index	LIFO Value
2002 Base Layer	$7,000	1.0000	$7,000
2003 Layer	1,000	1.0500	1,050
2004 Layer	500	1.1000	550
2005 Layer	500	1.1000	550
2006 Layer	0	1.1000	0
2007 Layer	1,000	1.2000	1,200
Total	$10,000		$10,350

Table 2 – New Truck Pool   12/31/2007

Layer	Base Cost	Index	LIFO Value
2004 Base Layer	$3,500	1.0000	$3,500
2005 Layer	1,000	1.1000	1,100
2006 Layer	500	1.1500	575
2007 Layer	0	1.1500	0
Total	$5,000		$5,175

To implement the change in method of pooling for these new vehicles, Reseller first restates the base cost of the newer pool (New Truck pool) in terms of the older pool's (New Car pool's) base year as shown in Table 3.

Table 3 Layers at Base Cost	New Truck Pool (original)	New Car Pool 2004 Cum. Index	New Truck Pool (restated)
2004 Base Layer	$3,500	1.1000	$3,182
2005 Layer	1,000	1.1000	909
2006 Layer	500	1.1000	454
2007 Layer	0	1.1000	0
Total	$5,000		$4,545
Layers at LIFO Value			
2004 Base Layer	$3,500		$3,500
2005 Layer	1,100		1,100
2006 Layer	575		575
2007 Layer	0		0
Total	$5,175		$5,175

Next, Reseller determines the current-year cost of the entire inventory. Assume that the current-year costs of Reseller's New Car pool and New Truck pool at December 31, 2007, are $12,000 and $5,750, respectively. As shown in Table 4, Reseller combines the base costs of the two pools (year by year) to create base costs for the New Vehicle pool (year by year) and combines the LIFO values of the two pools (year by year) to create the LIFO values for the New Vehicle pool (year by year).

Table 4 Summary	New Car Pool	New Truck Pool	New Vehicle Pool
Current-Year Cost	$12,000	$5,750	$17,750
÷ Cumulative Index	1.2000	1.2650(1)	
Base Cost	$10,000	$ 4,545	$14,545

(1) 1.15 [New Truck pool's 2007 cumulative index] * 1.10 [New Car pool's 2004 cumulative index]

Layers at Base Cost

2002 Base Layer	$7,000	$ 0	$7,000
2003 Layer	1,000	0	1,000
2004 Layer	500	3,182	3,682
2005 Layer	500	909	1,409
2006 Layer	0	454	454
2007 Layer	1,000	0	1,000
Total	$10,000	$4,545	$14,545

Layers at LIFO Value			
2002 Base Layer	$7,000	$ 0	$7,000
2003 Layer	1,050	0	1,050
2004 Layer	550	3,500	4,050
2005 Layer	550	1,100	1,650
2006 Layer	0	575	575
2007 Layer	1,200	0	1,200
Total	$10,350	$5,175	$15,525

Next, as shown in Table 5, Reseller revises each of the layer indexes to reflect the relationship between base cost and LIFO value for the New Vehicle pool.

Table 5 – New Vehicle Pool	Layers at Base	Revised	12/2007
Layers	Cost	Index	LIFO Value
2002 Base Layer	$7,000	1.0000	$7,000
2003 Layer	1,000	1.0500	1,050
2004 Layer	3,682	1.0999	4,050
2005 Layer	1,409	1.1710	1,650
2006 Layer	454	1.2665	575
2007 Layer	1,000	1.2000	1,200
Total	$14,545		$15,525

Next, Reseller restates the 2007 cumulative index of the New Vehicle pool as 1.2204 ($17,750 [current-year cost of New Vehicle pool] ÷ $14,545 [base cost of New Vehicle pool]). Then, Reseller restates the base year of the New Vehicle Pool to the current year. As shown in Table 6, Reseller multiplies the Layers at Base cost by the restated cumulative index of 1.2204.

Table 6 – Restated Layers	Layers at Base	Cumulative	Layers at Updated
Layers	Cost	Index	Base Cost
2002 Base Layer	$7,000	1.2204	$8,543
2003 Layer	1,000	1.2204	1,220
2004 Layer	3,682	1.2204	4,493
2005 Layer	1,409	1.2204	1,720

	2006 Layer	454	1.2204	554
	2007 Layer	1,000	1.2204	1,220
	Total	$14,545		$17,750

Next, as shown in Table 7, Reseller revises each of the layer indexes to reflect the relationship between base cost and LIFO value for the New Vehicle pool.

Table 7 – New Vehicle Pool Layers	Layers at Updated Base Cost	Revised Index	12/31/2007 LIFO Value
2002 Base Layer	$8,543	.8194	$7,000
2003 Layer	1,220	.8607	1,050
2004 Layer	4,493	.9014	4,050
2005 Layer	1,720	.9593	1,650
2006 Layer	554	1.0379	575
2007 Layer	1,220	.9836	1,200
Total	$17,750		$15,525

Finally, Reseller restates the 2007 *cumulative* index of the New Vehicle pool as 1.0000 ($17,750 [current-year cost of New Vehicle pool] ÷ $17,750 [base cost of New Vehicle pool]).

CONCLUSION:

If a reseller combines its new car and new truck pools (or used car and used truck pools) into a single vehicle pool as shown in *Example 1* or *Example 2*, whichever is applicable, Exam should not challenge the reseller's implementation of the change to the Vehicle-Pooling Method during an examination of the reseller's federal income tax return.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-4970 if you have any further questions.

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