Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **201043029**
Release Date: 10/29/2010

CC:ITA:B06:NMMulleneaux
POSTF-138399-09

UILC: 472.08-00, 472.08-04

date: July 20, 2010

to: Associate Area Counsel, Large & Mid-Size Business (LMSB), Area 2
(Heavy Manufacturing & Transportation)
Attn: Elizabeth R. Edberg

from: Willie E. Armstrong, Jr.
Senior Technician Reviewer, Branch 7
Income Tax & Accounting (ITA)

---

subject: Definition of Dollar-Value LIFO Inventory Items

This Chief Counsel Advice responds to your request for assistance. In accordance with 6110(k)(3), this Chief Counsel advice should not be cited as precedent.

LEGEND

Taxpayer =

Region =

Vineyard 1 =

Vineyard 2 =

a =

b =

c =

d =

e =

f	=
g	=
h	=
i	=
Grape 1	=
Grape 2	=
Grape 3	=
Grape 4	=
Reserve Varietal 1	=
Estate Varietal 1	=
Varietal 1	=
Varietal 2	=
Varietal 3	=
Varietal 4	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Month 1	=
Month 2	=

ISSUE

Whether Taxpayer properly defines items of inventory within its dollar-value, last-in, first-out (LIFO) pool for purposes of computing the LIFO price index of the pool in accordance with § 472 of the Internal Revenue Code and the Income Tax Regulations thereunder.

CONCLUSION

Taxpayer properly defines items within its dollar-value LIFO pool for purposes of computing the LIFO price index of the pool in accordance with § 472 and the regulations thereunder.

FACTS

Taxpayer is a winery that produces several types of wine and owns and operates two vineyards in Region: Vineyard 1 and Vineyard 2. Vineyard 1 contains a blocks of land, including b for Reserve Grape 1, c for Estate Grape 1, c for Grape 2, b for Grape 3, and b for Grape 4. Vineyard 2 contains d blocks of land, including e for Grape 3 and c for Grape 4.

In Year 1, Taxpayer's first vintage year, it produced Estate Varietal 1. In Year 2, Taxpayer began producing Varietal 2, Varietal 3, and Reserve Varietal 1. In Year 3, Taxpayer began producing Varietal 4 and continued to produce that varietal off and on through Year 4.

Taxpayer uses grapes grown within the same grape-growing geographical region (appellation) for its wine production and generally uses only estate-grown grapes. In some years, however, Taxpayer may purchase a small amount of Grape 1, Grape 2, Grape 3, and Grape 4 grapes to augment the estate-grown grapes if, and to the extent, there is a shortfall in the yield from its vineyards due to weather, insects, diseases, or other similar causes. Because the grape growing costs are expensed at the farming division level, the grapes grown at Taxpayer's vineyards are taken into inventory at a zero basis. Taxpayer does not purchase wine for resale.

Taxpayer generally designates about f percent of the best of its Grape 1 production for the Reserve Varietal 1 program. The vast majority of the grapes used in the program come from the Reserve Grape 1 block although some blending may occur. Indeed, for production years after Year 4, the bulk wine produced from Grape 4 grapes is used solely for blending into the Varietal 1 programs at the time of bottling.

Although vineyard practices at the Reserve Grape 1 block may vary slightly from the Estate Grape 1 blocks (timing of harvest, trellis systems, and canopy management may differ), from a practical standpoint, there is no difference in production methods or costs in the Reserve Varietal 1 program compared to the Estate Varietal 1 program. In this regard, the grapes are crushed, fermented, and barrel aged using the same methods and in the same location, up to the point of final blending decisions. At that point, the best barrels are identified for the Reserve Varietal 1 program and are subject to further barrel and/or bottle aging. The balance of the Varietal 1, along with any remaining Varietal 4 from that vintage, goes into the Estate Varietal 1 program where they are subject to the processes of blending, bottling, and bottle aging.

Traditionally, Taxpayer bottles its Varietal 2 in Month 1 of the year after harvest and releases the wine for sale shortly thereafter. The majority of that bottling will sell out within g months of bottling.

After a period of bulk aging, Taxpayer bottles its Varietal 3 in Month 2 of the year following harvest. The wine is then bottle aged for a period of about h months before its release for sale. Once released for sale, the majority of the bottled Varietal 3 is sold within g months.

After a period of aging, the Estate Varietal 1 is bottled in Month 3 of the i year after harvest, with a bottle aging period of about g months. The barrel and bottle aging periods are slightly longer for the Reserve Varietal 1 program. Both Varietal 1 programs generally sell out within g months of their respective releases.

Taxpayer defines items in its bulk wine by varietal: Varietal 1, Varietal 2, Varietal 3, and Varietal 4. It further defines bulk wine by length of production, i.e., time, in months, from the month the grapes are harvested (stage of production). Additionally, Taxpayer defines bulk wine by quality. Once bulk wine is determined to be of sufficient quality to be bottled as a “Reserve” (high quality) wine, Taxpayer treats such bulk wine as a separate item from the bulk wine of the same varietal and production period.
In general, Taxpayer defines items of bottled wine in a similar manner as bulk wine. It defines bottled wine by varietal, length of time it has been aged and stored, and the quality of the wine (e.g., Estate Varietal 1, Reserve Varietal 1). Taxpayer further defines items by the size of the bottle used, if the same item is bottled in containers of different sizes. For example, some wines are further defined by 750mL and 1.5L bottles.

To value its bulk and bottled wine inventory, Taxpayer uses the dollar-value, link chain, LIFO method. Taxpayer determines current-year cost using the latest acquisitions method. Taxpayer maintains one natural business unit pool.

LAW

Section 1.472-8(a) provides that any taxpayer may elect to determine the cost of its LIFO inventories using the dollar-value LIFO method, provided such method is used consistently and clearly reflects income. In order for Taxpayer’s dollar-value method to clearly reflect income, Taxpayer must properly define each inventory item used to calculate its LIFO index (inflation) and to measure increments and decrements in its LIFO pool.

In order to determine whether Taxpayer properly defined its LIFO items and consequently its LIFO index, it is helpful to first discuss the definition of the word "items" and "goods" in the context of § 472 and the importance of a taxpayer properly defining an inventory item within a pool for purposes of accurately measuring inflation and calculating the LIFO index for the pool.

A. Definition of the Terms "Goods" and "Items"

Neither the Code nor the Regulations set forth a definition of the words "goods" and "items." Section 1.472-8, however, seems to use the terms "goods" and "items" interchangeably when describing the dollar-value LIFO method. For example, § 1.472-8(a) provides that "goods contained in the inventory are grouped into a pool or pools." Section 1.472-8(b)(1) states in part, "[a] pool shall consist of all items entering into the entire inventory investment for a natural business unit of a business enterprise, unless the taxpayer elects to use the multiple pooling method provided in subparagraph (3) of this paragraph." Section 1.472-8(e)(2)(i) also refers to an "item" in the pool.

In legislative interpretation, "…words are uniformly presumed, unless the contrary appears, to be used in their ordinary and usual sense, and with the meaning commonly attributed to them." Caminetti v. United States, 242 U.S. 470, 485-486 (1917); see Consumer Product Safety Commission v. GTE Sylvania, Inc., 447 U.S. 102, 108 (1980). A similar presumption should be used with respect to words used in regulations. Thus, the term "goods" should be used in its ordinary meaning. The term "goods" is defined in Merriam-Webster's Collegiate Dictionary, at 527 (9th ed. 1984) as "personal property having intrinsic value . . . ; wares, commodities, merchandise . . . ." Therefore, using common usage, goods or items can include a broad group of wares or commodities.

The Tax Court has established a basic principle for the term "item" in the context of § 472. The Tax Court stated, "[a] narrow definition of an item within a pool will generally led to a more accurate measure of inflation (i.e., price index) and thereby lead to a clearer reflection of income." Amity Leather Products Co. v. Commissioner, 82 T.C. 726, 734 (1984). Thus, whether referencing "goods" or an "item," the goods or item placed in the inventory pool must provide an accurate measure of inflation.

Further, the cost of inventory items plays a significant role in defining an item. In Amity Leather, the Tax Court agreed with the taxpayer that billfolds manufactured in Puerto Rico should be treated for inventory purposes as different items from otherwise identical billfolds produced in the United States. The billfolds produced in Puerto Rico were substantially cheaper. See Hamilton Industries, Inc. v. Commissioner, 97 T. C. 120, 136 (1991) (goods may be placed in separate item categories because of their cost).

B. Importance of Defining Items Properly

Proper item definition is the foundation on which an accurate, reliable, and suitable LIFO index must be built. The LIFO index is generally defined as the ratio of the current cost of the goods in inventory to the base cost of those same goods. See § 1.472-8. Since a LIFO reserve measures cumulative inflation in the ending inventory, it is imperative that the LIFO index accurately measure inflation. In Amity Leather, the Tax Court recognized the importance of defining inventory items properly:

> Because the change in the price of an item determines the price index and that index affects the computation of increments or decrements in the LIFO inventory, the definition and scope of an item are extremely important to the clear reflection of income. If factors other than inflation enter into the cost of inventory items, a reliable index cannot be computed. For example, if a taxpayer's inventory experiences mix changes that result in the substitution of less expensive goods for more expensive goods, the treatment of those goods as a single item increases taxable income. . . . Conversely, if changes in mix of the inventory result in the substitution of more expensive goods for less expensive goods, the treatment of those goods as a single item decreases taxable income because the increase in inventory costs is eliminated from the LIFO cost of the goods as if such cost increase represented inflation.

Amity Leather, 82 T.C. at 733. This lengthy quotation emphasizes the importance of a taxpayer defining its items properly and explains that distortions can occur when the taxpayer does not properly define its items.

The Tax Court again emphasized this conclusion in Hamilton Industries when it stated:

> The proper grouping of goods into pools and items is central to the operation of the dollar-value method. Wendle Ford Sales, Inc. v. Commissioner, 72 T.C. 447, 452-453 (1979). In order to produce a clear reflection of income, the goods contained in a taxpayer's pool and item categories must have similar characteristics, as determined under the standards applicable to each. Amity Leather Products Co. v. Commissioner, 82 T.C. at 734-735. A system which groups like goods together and separates dissimilar goods permits cost increases attributable to inflation to be isolated and accurately measured. Amity Leather Products Co. v. Commissioner, 82 T C. at 731-734. The more homogenous that each category can be made, the better it will screen out cost increases caused by non-inflationary factors, thus producing a clearer reflection of income than would be possible with categories containing heterogeneous agglomerations of goods.

Hamilton Industries, 97 T.C. at 132 (footnote omitted). The taxpayer in Hamilton had elected the LIFO method and tried to include inventory purchased in two acquisitions in the same inventory pool as inventory manufactured after the acquisition. The Tax Court determined that the purchased inventory could be placed in the same pool as the later manufactured inventory but, despite the taxpayer's arguments, could not be treated as the same item for LIFO purposes because the values of the purchased inventory were too disparate from the costs of the manufactured inventory. Furthermore, the taxpayer could identify the inventory in question and track it at the time of purchase. Id. at 139.

ANALYSIS

A. Appropriate Criteria for Determining Item Definitions

If the inflation in Taxpayer's LIFO inventory is to be correctly and consistently measured, Taxpayer must properly define each item of wine in its inventory and the change in cost of its various wines must be identified and measured at the item level. The manner in which a winery should define "items" for LIFO purposes so that this goal is met is factually dependent, and the resulting item definitions may vary depending on the particular facts and circumstances of each winery.

Recognizing that not all criteria may be applicable to a particular winery, we believe that the factors noted below should be considered in defining an inventory item for a winery with regard to bulk wine, bottled wine, and cased goods.

Bulk Wine Item Definition Criteria

A winery should consider the following criteria when dividing the bulk wines that it produces into LIFO inventory items:

(1) Type of wine (e.g., varietal, appellation, or blend);
(2) Source of grapes (e.g., purchased or grown);
(3) Process, recipe, or formula used, or the program followed, to make the wine; and
(4) Length of time the wine has been in production or aging at the end of the tax year, from the time the grapes are harvested (*e.g.*, 3 months; 15 months; 27 months).

Bottled Wine and Cased Goods Item Definition Criteria

A winery should consider the following criteria when dividing bottled wines and cased goods into LIFO inventory items:

(1) Type of wine (e.g., varietal, appellation, or blend);
(2) Source of grapes (e g., purchased or grown);

(3) Process, recipe, or formula used, or the program followed, to make the wine;
(4) If the wine if aged in the bottle, the length of time the bottled wine has been aging when bottled;
(5) Type and size of container, if a significant cost difference exists between types or sizes of containers; and
(6) Length of time the wine has been stored after bottling.

Aside from these criteria, additional factors may be applicable to defining an item of wine. The application of additional factors will depend on the facts and circumstances related to a particular winery.

As to type of wine, each varietal, appellation, and blend should be defined as a separate item. For this purpose, a blend generally is a wine made from mixing together two or more wines or varietals. The term appellation refers to a defined viticultural growing region, whereby specific grape varietals are grown, harvested, and made into wine.

Regarding source of grapes, wines made with purchased grapes and wines made with estate-grown grapes should generally be treated as separate items due to their cost differences. However, where a taxpayer purchases grapes if, and only to the extent, there is a shortfall in the yield from its vineyard due to weather, insects, diseases, or other similar causes, the taxpayer need not under such circumstances separate wines into separate items on the basis that some of the grapes used to make wine, otherwise made with estate grapes, were purchased.

For purposes of defining an item of wine, the terms “process,” “recipe,” “formula,” and “program” mean a set of directions, techniques, or procedures regularly followed, as well as a set of ingredients regularly used, to produce a distinct product (i.e., wine with specific taste, quality or grade, cost, and price point). For example, if the taxpayer uses different quality grapes of the same varietal to produce a high quality wine and a medium quality wine, the two wines should be treated as separate items. On the other hand, if the taxpayer uses the same quality grapes and some of the resulting wine has a higher quality than, or will be marketed as a different wine from, the remainder of the wine produced using these grapes, the taxpayer will not treat this wine as two items based solely on the process, recipe, formula, or program criteria.

As to length of time wine has been aging or in production, wines with different ages or at different stages of production such as the current year’s production, one-year bulk wine, and two-year bulk wine, etc., should be separate items. This is because treating wines that are at different stages of production as the same item would not create an accurate measure of inflation or result in a correct LIFO index. For example, two-year bulk wine would have more production and storage costs applied to it than the current year’s production, or than one-year bulk wine. Therefore, if two-year bulk wine and one-year bulk wine were treated as the same item for purposes of computing a LIFO index, the LIFO index would be distorted as a result of the artificial inflation created by the two-year bulk wine’s additional costs.

B. Application of Criteria to Taxpayer

Bulk Wine Item Definitions

Taxpayer properly applies the above criteria to bulk wine as follows:

(1) Taxpayer properly defines its bulk wine by varietal. Taxpayer does not need to distinguish its bulk wine by appellation because Taxpayer only uses grapes grown within the same appellation.

(2) Taxpayer properly defines bulk wine by source of grapes. Taxpayer primarily uses estate-grown grapes. Taxpayer uses purchased grapes only if, and to the extent, there is a shortfall in the yield of grapes from its vineyard due to weather, insects, diseases, or other similar causes. Therefore, Taxpayer does not need to distinguish wine on the basis of the use of purchased grapes versus estate-grown grapes.

(3) Taxpayer properly defines bulk wine by process, recipe, or formula used. Taxpayer also properly defines bulk wine by quality. Once Taxpayer's Varietal 1 is determined to be of sufficient quality to be bottled as a "Reserve" wine, this higher-quality bulk wine becomes a separate item.

(4) Taxpayer properly defines its bulk wine by the stage of production or length of time the bulk wine has been aging or in production.

Bottled Wine and Cased Goods Item Definitions

Taxpayer properly applies the above criteria to bottled wine as follows:

(1) Taxpayer properly defines its bottled wine by varietal. Taxpayer does not need to distinguish its bottled wine by appellation because Taxpayer only uses grapes grown within the same appellation.

(2) Taxpayer properly defines bottled wine by source of grapes. Taxpayer primarily uses estate-grown grapes. Taxpayer uses purchased grapes only if, and to the extent, there is a shortfall in the yield of grapes from its vineyard due to weather, insects, diseases, or other similar causes. Therefore, Taxpayer does not need to distinguish wine on the basis of the use of purchased grapes versus and estate-grown grapes.

(3) Taxpayer properly defines bottled wine by process, recipe, or formula used. Taxpayer also properly defines bottled wine by quality. Once Taxpayer's Varietal 1 is determined to be of sufficient quality to be bottled as a "Reserve" wine, this higher-quality bulk wine becomes a separate item.

(4) Taxpayer properly defines bottled wine by length of time it has been aged and stored.

(5) Taxpayer properly defines bottled wine by the type and size of container used. Taxpayer treats as separate items wine bottled in 750 mL containers and 1.5 L containers.

Based on the facts presented, Taxpayer does not consider goods that do not have similar characteristics as the same item. Rather, Taxpayer defines items of wine in a manner that allows for an accurate measure of inflation. Taxpayer appropriately subdivides bulk wine and bottled wine into inventory items based on factors such as varietal, quality, length of time of aging, and other criteria noted. Therefore, Taxpayer properly defines items within its dollar-value LIFO pool for purposes of computing the LIFO price index of the pool in accordance with § 472 and the regulations thereunder.

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.