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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Components of Cost

This Field Service Advice responds to your memorandum dated August 12, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer =
Taxable Year 1 =
Production Facility =
x% =

ISSUES

1. Whether Taxpayer's application of the last-in, first-out (LIFO), components of cost method clearly reflects income.
2. If not, what accounting method should the Service change Taxpayer to that clearly reflects income?

CONCLUSIONS

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1. Taxpayer's LIFO, components of costs method does not clearly reflect income for the reason that it fails to take into account efficiency gains in labor and overhead which the Taxpayer experienced.

2. The Service should change Taxpayer to a components of cost method that is akin to the total product cost method by factoring out productivity gains in the labor and overhead cost components. Alternatively, if Taxpayer does not maintain sufficient books and records to enable the Service to change Taxpayer to this method, the Service should change Taxpayer to the first-in, first-out (FIFO) method.

FACTS

Taxpayer is a manufacturer which uses the accrual method of accounting. Taxpayer is the parent company of an affiliated group of corporations filing consolidated federal income tax returns on a calendar year basis. Taxpayer has many separate production plants or facilities.

Taxpayer adopted the LIFO method for its entire inventories in Taxable Year 1. As part of this election, it adopted the natural business unit (NBU) method of pooling, the earliest acquisitions cost method of determining current-year cost, and the link-chain method of determining its price index.

Taxpayer uses a LIFO, components of cost ("COC") method. Under this method, "items" of inventory are not the physical units in the stages of production, *i.e.*, raw materials, work-in-process and finished goods. Instead, Taxpayer's items are defined by reference to the three cost components -- raw material, labor, and overhead. On Taxpayer's original Form 970 (Election to Use the LIFO Method), Taxpayer's LIFO pool consisted of what it called "LIFO elements." These LIFO elements essentially were various categories of Raw Materials; Labor; and various categories of Overhead. In determining the appropriate price index for its pool, Taxpayer computes a separate index for each plant location. Although plant locations have changed to some degree over the years, Taxpayer's LIFO, COC method has remained substantially unchanged.

Taxpayer double-extends each distinct raw material at both end-of-the-year and beginning-of-the-year costs based on purchase costs during the last three months of the taxable year. Taxpayer uses the resulting annual index in computing the cumulative index under its link-chain method.

Taxpayer's labor component is further broken down into specific products at some locations. That is, in determining its overall price index for the pool, Taxpayer separately measures its labor output per hour for each separate facility.

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The input data used to determine the amount of labor in Taxpayer's ending inventory is also based on the last three months of production. Ultimately, however, Taxpayer's labor component of its price index is based exclusively on the ratio of labor hours to labor dollars.

Taxpayer breaks down its overhead cost component into multiple "items," including indirect labor, depreciation, insurance, obsolescence, taxes and purchased utilities. Taxpayer determines separate sub-indexes for each item -- again, based on the immediately preceding three months of relative through-put. These indexes are not derived by comparison of ratios, but are determined based on observed economic price changes.

The Examining Agent has used standard cost comparisons at one of Taxpayer's plants, the Production Facility, to establish that Taxpayer has incurred labor efficiencies. While Taxpayer does not disagree that there were labor efficiencies at the Production Facility, Taxpayer contends that almost all of its labor efficiencies (that are, in the aggregate, minimal) occurred in one type of manufacturing operation and that the Production Facility is primarily engaged in that one type of manufacturing. Taxpayer contends that primary manufacturing operations have remained substantially unchanged over the years because those operations are capital rather than labor intensive. Furthermore, the Production Facility makes up about x% of Taxpayer's total inventory, which is a relatively small percentage of total inventory in Taxpayer's NBU pool.

There are some indications that there may also be some overhead efficiencies, due to savings associated with utilities on newer equipment.

LAW AND ANALYSIS

I.R.C. § 446(a) 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 446(b) of the Internal Revenue Code provides that if the accounting method used by the taxpayer does not clearly reflect income, the computation shall be made under such method as, in the opinion of the Commissioner, clearly reflects income.

Pursuant to section 446, the Commissioner has broad powers to determine whether an accounting method used by a taxpayer clearly reflects income. United States v. Hughes Properties, Inc., 476 U.S. 593, 603 (1986); Commissioner v. Hansen, 360 U.S. 446, 467 (1959); Ansley-Sheppard-Burgess Co. v.

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Commissioner, 104 T.C. 367, 370 (1995). Courts may not interfere with the Commissioner's determination under section 446 unless it is clearly unlawful or plainly arbitrary, *i.e.*, an abuse of discretion. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532 (1979); Cole v. Commissioner, 586 F.2d 747, 749 (9th Cir. 1978), *cert. denied*, 441 U.S. 924 (1979). To prevail, the petitioner must prove that the Commissioner's determination is arbitrary and capricious or without sound basis in law or fact. Ansley-Sheppard-Burgess Co. v. Commissioner, 104 T.C. at 370-371; Ford Motor Co. v. Commissioner, 102 T.C. 87, 91-92 (1994), *aff'd*, 71 F.3d 209 (6th Cir. 1995).

The Commissioner's determination with respect to clear reflection of income is entitled to more than the usual presumption of correctness, and the taxpayer bears a heavy burden of overcoming a determination that a method of accounting does not clearly reflect income. Hamilton Industries v. Commissioner, 97 T.C. 120 (1991). Whether a particular method of accounting clearly reflects income is a question of fact which must be decided on a case-by-case basis. Peninsula Steel Products & Equipment Co. v. Commissioner, 78 T.C. 1029, 1045 (1982). The Commissioner's determination as to the proper method of accounting for inventory must be upheld unless shown to be plainly erroneous. Lucas v. Kansas City Structural Steel Co., 281 U.S. 264, 271 (1930); Hamilton Industries, 97 T.C. at 129.

Section 471 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.

Treas. Reg. § 1.471-1 provides that in order to reflect taxable income correctly, inventories at the beginning and the end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of the merchandise intended for sale.

Section 472(a) provides that a taxpayer may use the last-in, first-out method, described in section 472(b), in inventorying goods specified in an application to use such method filed at such time and in such manner as the Secretary may prescribe. The change to, and the use of, such method shall be in accordance with such regulations as the Secretary may prescribe as necessary in order that the use of such method may clearly reflect income.

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Section 472(b) provides that in inventorying goods specified in the application described in section 472(a), the taxpayer shall:

- (1) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof; and second, those acquired during the taxable year;
- (2) Inventory them at cost; and
- (3) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method.

Treas. Reg. § 1.472-1(a) provides that any taxpayer permitted or required to take inventories pursuant to the provisions of section 471 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 Treas. Reg. § 1.472-2.

Treas. Reg. § 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.

Treas. Reg. § 1.472-2 provides that except as otherwise provided in Treas. Reg. §1.472-1 with respect to raw material computations, retail inventory computations, and other methods of computation established to the satisfaction of the Commissioner as reasonably adapted to the purpose and intent of section 472, and in Treas. Reg. § 1.472-8 with respect to the dollar-value method, the adoption and use of the LIFO inventory method is subject to the following requirements:

- (a) The taxpayer shall file an application to use such method specifying with particularity the goods to which it is to be applied.
- (b) The inventory shall be taken at cost regardless of market value.
- (c) 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

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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.

Treas. Reg. § 1.472-3(a) provides that the LIFO inventory method may be adopted and used only if the taxpayer files a statement of his election to use such inventory method. Such statement shall be accompanied by an analysis of all inventories of the taxpayer as of the beginning and as of the end of the taxable year for which the LIFO method is proposed first to be used, and also as of the beginning of the prior taxable year. In the case of a manufacturer, this analysis shall show in detail the manner in which costs are computed with respect to raw materials, goods in process, and finished goods, segregating the products (whether in process or finished goods) into natural groups on the basis of either (1) similarity in factory processes through which they pass, or (2) similarity of raw materials used, or (3) similarity in style, shape, or use of finished products. Each group of products shall be clearly described.

Treas. Reg. § 1.472-3(d) provides that whether or not the taxpayer's application for the adoption and use of the LIFO inventory method should be approved, and whether or not such method, once adopted, may be continued, and the propriety of all computations incidental to the use of such method, will be determined by the Commissioner in connection with the examination of the taxpayer's income tax returns.

Treas. Reg. § 1.472-4 provides that a taxpayer may not change to the LIFO method of taking inventories unless, at the time he files his application for the adoption of such method, he agrees to such adjustments incident to the change to or from such method, or incident to the use of such method, in the inventories of prior taxable years or otherwise, as the district director upon the examination of the taxpayer's returns may deem necessary in order that the true income of the taxpayer will be clearly reflected for the years involved.

Treas. Reg. § 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 the dollar-value LIFO method, the goods contained in the inventory are grouped into a pool or pools as described in Treas. Reg. §§ 1.472-8(b) and (c). The term base-year cost is the aggregate of the cost

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(determined as of the beginning of the taxable year for which LIFO is adopted) of all items in a pool.

Treas. Reg. § 1.472-8(b)(1) provides that 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 Treas. Reg. §1.472-8(b)(3).

Treas. Reg. § 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 Treas. Reg. § 1.472-8(b)(1). 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 inventory items subject to the dollar-value LIFO method and the significance of such items to the taxpayer's business operations.

Treas. Reg. § 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.

Treas. Reg. § 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.

Treas. Reg. § 1.472-8(b)(3)(i)(d) provides the requirement that pools be established by major types of materials or major classes of goods is not to be construed so as to preclude the establishment of a miscellaneous pool. Since a taxpayer may elect the dollar-value LIFO method with respect to all or any designated goods in his inventory, there may be a number of such inventory items

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covered in the election. A miscellaneous pool shall consist only of items which are relatively insignificant in dollar value by comparison with other inventory items in the particular trade or business and which are not properly includible as part of another pool.

Treas. Reg. § 1.472-8(b)(3)(ii) provides that the dollar-value method of pricing LIFO inventories may be used in conjunction with the raw materials content method authorized in Treas. Reg. § 1.472-1. Raw materials (including the raw material content of finished goods and goods-in-process) which are substantially similar shall be pooled together in accordance with the principles for establishing multiple pools under Treas. Reg. § 1.472-8(b)(3)(i).

Background

Under the components of cost method, "items" of inventory are not the physical units as they are under a total product cost ("TPC") method. Instead, the physical units are exploded into their cost components -- generally, raw material, direct labor, and overhead. One unit of a finished good is not inventoried as such. Instead, a taxpayer using the components of cost method separately inventories the quantities of input of material, labor and overhead necessary to manufacture the number of physical units of the product in the taxpayer's ending inventory.

Historically, some have questioned whether the COC method comports with the regulations. In a letter sent to the American Institute of Certified Public Accountants (AICPA) dated July 31, 1992, however, the Chief Counsel and the Commissioner stated that the current regulations neither specifically permit nor proscribe the use of the COC method and that specific applications of the method would be evaluated as to whether they clearly reflected income. Later legislative proposals have suggested proscribing the COC method, based on the distortions which may arise from its use. See Staff of the Joint Committee on Taxation, 103d Cong., 2d. Sess., Description of Proposals Relating to Financing the Implementation of the Uruguay Round Agreement of the General Agreement on Tariffs and Trade (GATT)2, Comm. Print (JCX-13-94 August 5, 1994) ("[T]he COC method as applied by some taxpayers may produce different results than the TPC method whenever a taxpayer's production processes change between the base year and the current year."). None of the legislative proposals have been enacted.

The Service has identified three distortions that may arise as a result of using the COC method. These distortions are the result of (1) failing to reflect efficiency gains;

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(2) substituting of one item for another within a cost component ("item within an item"); and (3) establishing interdependence between the overhead and direct labor cost components ("double dip" or "frozen burden"). Any or all of the distortions can occur depending on the taxpayer's particular facts.

The efficiency gain distortion occurs because component costing essentially reconstructs base-year cost of products using technology available only in the current year. Thus, for example, if two direct labor hours are required to produce good X in the base year and, due to technological change or other factors, only one direct labor hour is required to produce good X in the current year, the components of cost method produces the same result as if, under the total product cost method, one hour of direct labor was used to reconstruct the base-year cost of good X. This can result in base-year costs that are below what it actually cost to produce good X in the base-year. This is a natural consequence of using the components of cost method because the quantity of each cost component in ending inventory will invariably relate to current production.

The "item within an item" problem arises as a result of COC taxpayers not maintaining different items of direct labor. Thus, if unskilled and skilled labor are treated as the same item, a change in usage from one hour of unskilled labor to one hour of skilled labor will result in the wage differential between unskilled and skilled labor being improperly treated as inflation. For example, if it currently takes two hours of unskilled labor, at \$10/hr. to produce good X and the producer changes to using one hour of skilled labor at \$20/hr. to produce good X, the total direct labor cost of producing good X has remained unchanged. However, if the two classes of direct labor are treated as the same item, then the hourly wage differential would be improperly treated as 100 percent inflation ($\$20/\10).

The "double dip" or "frozen burden" problem arises from difficulty in independently quantifying and measuring the inflation for overhead. Direct labor hours or dollars are frequently used to allocate overhead in taxpayers' underlying cost accounting systems. Computing a price index for overhead based on the change in the relationship between overhead and direct labor will superimpose any direct labor efficiency gain onto the overhead cost component even where direct labor efficiency gains are achieved by increasing overhead (e.g., depreciation on high-tech equipment). For example, if a taxpayer incurs \$1 of overhead per direct labor hour in the base-year and now incurs \$2 of overhead per direct labor hour (due to labor efficiency gains) and taxpayer uses this relationship ($\$2/\1) as the basis for computing its price index, it will be deemed to have incurred 100 percent inflation [$(\$2/\$1) = 2.0$].

Issue 1

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The common thread in the Commissioner and Chief Counsel's letter to the AICPA as well as past legislative proposals to explicitly proscribe the use of the COC method is that the method may not clearly reflect income if base-year cost is reconstructed using a different process or technology than actually existed in the base year. The result is that the base-year cost reconstruction using the technology in the current year (and the labor hours required in the current year) coupled with the prices in the base year (e.g., the wage rate per hour) results in a base-year cost lower than what the taxpayer could have actually produced the particular product for in the base-year.¹

Although Taxpayer's COC method does not have the double dip (frozen burden) problem, your incoming memorandum argues that Taxpayer's COC method fails to clearly reflect income because it does not have a mechanism to eliminate in its LIFO valuation the efficiencies in labor or overhead it has experienced. We agree.

Taxpayer's COC method does not properly take into account only inflationary price increases (or deflationary price decreases) at the product level, the principal objective of, and underlying rationale for, the use of the LIFO method. See Amity Leather Products, Inc. v. Commissioner, 82 T.C. 726 (1984); Hamilton Industries, Inc. v. Commissioner, 97 T.C. 120 (1991). Furthermore, there is evidence that for at least a portion of Taxpayer's total inventory, the inventory at the Production Facility, Taxpayer has incurred labor efficiencies. Additionally, there are some indications that there may also be some overhead efficiencies, although to what extent has yet to be completely determined.

The Examining Agent has used standard cost comparisons at one of Taxpayer's plants, the Production Facility, to establish that Taxpayer has incurred labor efficiencies. Taxpayer agrees that there were efficiencies, but argues that labor efficiencies were associated almost exclusively with the manufacturing

¹ The July 31, 1992, letter from the Commissioner and Chief Counsel to the AICPA. specifically provided:

After reviewing with our staffs the various possible applications of the components-of-cost method, we have concluded that the method has the potential to distort income by permitting a taxpayer to deduct as the cost of goods sold an amount greater than the current cost of creating the inventory sold. Some applications of the method can convert the changes in the component mix (often occasioned by technological advances) into apparent inflation in the cost of the inventory, even though overall product costs have not increased.

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process done at the Production Facility, which were different from the primary manufacturing processes done at other plants. Additionally, Taxpayer argues that the standard cost comparisons at the Production Facility are not representative of the entire NBU pool, given the small percentage of the Production Facility as part of the NBU pool. We believe that actual labor efficiencies proved at the Production Facility illustrate by example the flaws in the Taxpayer's overall use of its particular COC method of accounting. Finally, we note that the Producer Price indexes published by the United States Bureau of Labor Statistics (BLS) reflect modest productivity increases for the Taxpayer's industry as a whole during the applicable period, providing some corroborative support that the standard cost information from the Production Facility is sufficient to establish that Taxpayer's COC method does not clearly reflect income.

Pursuant to section 446, the Commissioner has broad powers to determine whether an accounting method used by a taxpayer clearly reflects income. United States v. Hughes Properties, Inc., 476 U.S. 593, 603 (1986); Commissioner v. Hansen, 360 U.S. 446, 467 (1959); Ansley-Sheppard-Burgess Co. v. Commissioner, 104 T.C. 367, 370 (1995). Courts may not interfere with the Commissioner's determination under section 446 unless it is clearly unlawful or plainly arbitrary, *i.e.*, an abuse of discretion. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532 (1979); Cole v. Commissioner, 586 F.2d 747, 749 (9th Cir. 1978), cert. denied, 441 U.S. 924 (1979). To prevail, the petitioner must prove that the Commissioner's determination is arbitrary and capricious or without sound basis in law or fact. Ansley-Sheppard-Burgess Co. v. Commissioner, 104 T.C. at 370-371; Ford Motor Co. v. Commissioner, 102 T.C. 87, 91-92 (1994), aff'd, 71 F.3d 209 (6th Cir. 1995).

The Examining Agent has established that Taxpayer has actually experienced labor and overhead efficiency gains. Taxpayer's COC method fails to take into account those labor and overhead efficiencies. Based on these facts and based on the authority cited above, we agree that Taxpayer's COC method does not clearly reflect income.

Issue 2

The Commissioner's determination with respect to clear reflection of income is entitled to more than the usual presumption of correctness, and the taxpayer bears a heavy burden of overcoming a determination that a method of accounting does not clearly reflect income. Hamilton Industries v. Commissioner, 97 T.C. 120 (1991). The Commissioner's determination as to the proper method of accounting for inventory must be upheld unless shown to be plainly erroneous. Lucas v. Kansas City Structural Steel Co., 281 U.S. 264, 271 (1930); Hamilton Industries, 97 T.C. at 129. The Service may not, however, require the taxpayer to change to

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another method that does not clearly reflect income. Dayton Hudson Corporation v. Commissioner, 153 F.3d 660 (8th Cir. 1998).

In the LIFO area, the Service appears to have more discretion in changing a taxpayer's method of accounting and/or proposing adjustments based on two sections of the regulations. First, Treas. Reg. § 1.472-3(d) provides that the taxpayer's continued use of the LIFO method and the propriety of all LIFO computations is determined by the Commissioner in connection with the examination of the taxpayer's return. Second, Treas. Reg. § 1.472-4 provides that the taxpayer is not even permitted to change to the LIFO method unless it agrees to adjustments incident to the use of such method in inventories of prior years or otherwise as the District Director may deem necessary in order to clearly reflect income. Treas. Reg. § 1.472-3(d) permits the Service to condition a taxpayer's continued use of LIFO on making adjustments the Service reasonably believes are necessary in order for the taxpayer's method to clearly reflect income.

In this case, several different courses of action are available to the Service. First, the Service could attempt to adjust Taxpayer's labor component index computation for productivity experienced at the Production Facility. Alternatively, the Service could make adjustments to Taxpayer's labor index based on some external measure of labor productivity such as the "all manufacturers" labor productivity index published by the BLS or the specific labor productivity measured by the BLS for the 4-digit Standard Industrial Classification code for this industry, but only if the Examining Agent determined that the external index is suitable, reliable, and accurate for Taxpayer.

We believe that the best course of action would be to request Taxpayer to provide standard cost information and the extent of productivity based on these costs that would fairly represent the efficiency gains applicable to Taxpayer's NBU pool. Taxpayer's price index should be decreased accordingly. There is no established method for evaluating overhead efficiencies. Taxpayer's overhead could be reallocated based on direct labor hours and then adjusted by the same labor efficiency factor determined for the direct labor cost component. We believe that such taxpayer-specific adjustments would be reasonable and would directly remedy the specific problems identified with the Taxpayer's COC method. In summary, we believe proposing these adjustments is a reasonable and legally sustainable approach in this case.

If Taxpayer does not possess, or is unwilling to provide, this internal standard cost information, we recommend changing Taxpayer to the FIFO method.

In a recent case, the Tax Court held that section 446(b) "permits respondent to terminate a taxpayer's method of accounting that does not clearly reflect income

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(here, Consolidated's LIFO method) and to require the taxpayer to use a method (here, the FIFO inventory method) that does clearly reflect income." Consolidated Manufacturing, 111 T.C. at 40. Significantly, the Court also indicated that Treas. Reg. § 1.472-3(d) gives the Service discretion to determine when a taxpayer's application to use LIFO should be approved or continued. In addition, the court also noted that Rev. Proc. 79-23, 1979-1 C.B. 564, does not provide an exclusive list of situations in which the Service may terminate a taxpayer's LIFO election. Moreover, the Court held that one of the grounds enumerated for termination in Rev. Proc. 79-23 is a taxpayer's failure to properly elect the LIFO method and concluded that because the taxpayer did not elect LIFO for the entire good, its election was indeed improper because, when taken together, these costs do not represent earlier produced goods. Instead, they represent the cost component input quantities relating to the most recently produced goods. See also Mountain State Ford Truck Sales, Inc. v. Commissioner, 112 T.C. 58, 82 (1999) (suggesting that failure by the taxpayer to state its inventories at costs warrants the termination of its LIFO election under sec. 3.01(c), Rev Proc. 79-23, even though the Service did not in fact terminate that taxpayer's election.)

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED] First, we have based our response on the notion that Taxpayer's COC method, in theory, does not clearly reflect income because it fails to take into account efficiency gains and potentially has item substitution. While the cases of Consolidated Manufacturing and Mountain State Ford give us some comfort regarding the use of a method of accounting not specifically enumerated in the Code or LIFO regulations, [REDACTED]

More importantly, the support for the theory is based on findings involving the Production Facility, where the Examining Agent has shown, with standard cost information, that there have been labor efficiencies. But Taxpayer has indicated that the processes carried on at the Production Facility are different from the primary manufacturing processes of the company as a whole, and that there have been no such labor efficiencies in the primary manufacturing processes. In fact, you note that overall labor efficiencies for Taxpayer were, in the aggregate, minimal. This is consistent with Taxpayer's argument that using data from the Production Facility is akin to the "worst case scenario" and not reflective of Taxpayer's true labor efficiency gains (or lack thereof). If the data from the Production Facility were not used and the remaining labor efficiencies in the other plants and the company as a whole were minimal, the distortion caused by Taxpayer's COC method would likewise be minimal. Such distortions might then be within a tolerance such that the method clearly reflected income. Furthermore, the

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total inventory of the Production Facility represents only x% of Taxpayer's overall inventory, a number which is significantly less than one-third or one-quarter of the total inventory. [REDACTED]

[REDACTED]

[REDACTED] Under the Eighth Circuit holding in Dayton Hudson, if the government's proposed method of accounting does not clearly reflect income, a taxpayer is permitted to remain on its method of accounting, no matter how flawed. Trying to use BLS indexes to adjust Taxpayer's COC method also carries some risks, which are more problematic for Taxpayer's overhead efficiencies because these are not measured for separate industries involving the relationship between capital and labor and the resulting "multi-factor productivity." The final recommendation, termination of LIFO, additionally involves risks. As we noted above, while the cases of Consolidated Manufacturing and Mountain State Ford give us some comfort regarding the Commissioner's authority to terminate the LIFO election, there are always serious risks in outright termination, especially because the LIFO reserve would be included in income in the year of change.

Overall, it is our view that the COC method as used by Taxpayer does not clearly reflect income, and that the Commissioner has the authority, if Taxpayer does not have the records, to terminate Taxpayer's COC method and place Taxpayer on the FIFO method. Or perhaps, if it were possible to segregate the facility, we could change the Production Facility to the FIFO method for the year under examination. We believe that theoretically the COC method used by Taxpayer will distort income because it will fail to take into account efficiencies in labor and overhead. We also believe, however, that we must point to specific factual circumstances that illustrate our theory. [REDACTED]

Please call if you have any further questions.

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