

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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subject: Calculation of LIFO Index

EIN:

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

LEGEND

Amount 1 =

A Percent =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Grape 1 =  
Grape 2 =  
Grape 3 =  
Grape 4 =  
Grape 5 =  
Grape 6 =  
Grape 7 =  
Grape 8 =

Inventory 1 =  
Inventory 2 =  
Inventory 3 =  
Inventory 4 =  
Inventory 5 =  
Inventory 6 =

Price 1 =  
Price 2 =  
Price 3 =

Report 1 =  
Report 2 =

Statistic 1 =  
Statistic 2 =

Tax 1 =

Tax Year 1 =  
Tax Year 2 =

Taxpayer =

Wine 1 =  
Wine 2 =  
Wine 3 =

Year 1 =  
Year 2 =  
Year 3 =  
Year 4 =

ISSUE

Whether \_\_\_\_\_ has properly determined its LIFO index by maintaining two “items” of dollar-value LIFO inventory in accordance with Internal Revenue Code (“I.R.C.”) section 472 and the associated regulations.

CONCLUSION

\_\_\_\_\_ has not properly determined its LIFO index in accordance with I.R.C. section 472 and its regulations because it has not defined its dollar-value LIFO “items” narrowly enough.

FACTS

\_\_\_\_\_ produces bottled wines. The Internal Revenue Service (“Service”) is currently auditing \_\_\_\_\_’s tax years ending \_\_\_\_\_ and \_\_\_\_\_. \_\_\_\_\_ elected to value inventories under the dollar-value, double extension, last-in, first-out (LIFO) method beginning in \_\_\_\_\_.<sup>1</sup> For the tax years currently under audit, \_\_\_\_\_ is a C corporation and files a consolidated return. \_\_\_\_\_ uses LIFO for purposes of valuing its domestic wine production operations only.

In \_\_\_\_\_, \_\_\_\_\_’s total first-in, first-out (FIFO) inventory net of assigned field costs was slightly more than \$ \_\_\_\_\_. By tax year \_\_\_\_\_, the total FIFO inventory exceeded \$ \_\_\_\_\_. During the tax years ending \_\_\_\_\_ and \_\_\_\_\_, \_\_\_\_\_ produced approximately \_\_\_\_\_ different wine labels each of which represented a distinctly identifiable grape table wine. The wines may differ from one another for a number of reasons including, but not limited to, the following:

1. Different grapes used
2. Different locations where grapes used were grown
3. Different grape growers
4. Different bottles
5. Different labels
6. Different aging requirements
7. Different aging containers
8. Different bottle seals
9. Different packaging

For purposes of determining its LIFO inventory value, \_\_\_\_\_ places all of its wine into a single pool. The pool includes two items: bulk wine and case goods. Bulk wine is wine

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<sup>1</sup> On \_\_\_\_\_, it elected to become an S corporation and incurred a tax of \$ \_\_\_\_\_ arising from its LIFO recapture amount under I.R.C. section 1363(d). \_\_\_\_\_ revoked its S election as of \_\_\_\_\_ and began filing as a C corporation again for the tax year ending \_\_\_\_\_. In \_\_\_\_\_, \_\_\_\_\_ changed from a calendar tax year to a fiscal tax year ending \_\_\_\_\_.

in process but not packaged in finished containers. Case goods are finished goods that have been packaged and are either being aged in a bottle or are ready for sale.

determines its LIFO index by first extending the quantity of goods on hand at year-end at both base-year cost and current-year cost, and then dividing the extended current-year cost by the extended base-year cost. If the current year inventory at base cost had created an increment, the index would have been applied to such increment in determining the current year LIFO layer. However, in both of the taxable years under audit, there were base cost decrements, causing the complete or partial liquidation of some prior year layers. All LIFO layers from base year to current year are totaled to arrive at the tax basis LIFO inventory at year end.

#### A. Bulk Wines

For bulk wine, summarizes all production (I.R.C. section 471) costs within the corporation for the tax period and divides that total by the total number of gallons of wine produced in the period. As a result, all in-process wines are allocated the same current cost per gallon for purposes of 's tax LIFO computation.

produces its bulk wine by first harvesting grapes at its owned or leased vineyards. A vineyard may grow various different grape varieties. Some grapes are picked manually while others are harvested mechanically. All harvesting costs at the vineyard are accumulated and divided by the quantity (tons) of grapes produced at that vineyard. As a result, all grape production costs are the same for the different grapes produced at any particular vineyard. The cost of a ton of grapes would be identical to the cost of a ton of grapes at that vineyard. Because costs can vary between vineyards, the cost of a ton of grapes will be different, depending on the vineyard where the grapes were grown. In addition, often supplements its own grape production by purchasing grapes or bulk wine from related parties and third parties. Purchased grape and bulk wine costs are independent of produced grape costs. These costs are specifically allocated to the appropriate wine varietal in 's

During fiscal years ended and , 's system was unable to track accurately the cost of wine that had been blended. Therefore, stated its accounting records were not capable of supplying the grape growing costs or purchased grape/bulk wine costs by specific product.

After harvesting the grapes and preparing the wine for storage, stores the bulk wine in different vessels, ranging from stainless steel tanks to American oak barrels to more expensive French oak barrels. The cost of the storage vessels varies significantly. Aging time also varies significantly depending on the type of grape being aged. Costs accumulate during storage (primarily blending, testing, and facility overhead costs). Thus, when stored for a longer period, the costs associated with a wine increase. places a bar code on each barrel in order to identify the kind of grape, the date injected

into the vessel, and the specific vineyard that produced the grapes. In its Bulk Wine Inventory Valuation in Dollars and Bulk Wine Roll Forward reports, allocates total crush and cellar costs to its bulk wine inventory on a per gallon basis.

Under 's LIFO method, all bulk wine produced within the corporation has the same cost per gallon. Inflation on bulk wine is measured by comparing the current cost per gallon for bulk wine to the base cost per gallon for bulk wine. is unable to provide a listing, including cost and quantity, of the different bulk wines in the base inventory.

## B. Case Goods

For case goods, adds additional production costs to the cost of the fully aged wine, many of which are a combination, or blend, of two or more aged wines. Production costs include additional materials, including bottles, bottle sealers, labels, and packaging materials. purchases a number of physically different bottles with varying costs. also seals the bottles in different ways. Some wines have cork stoppers. Within that group, the corks used can vary in cost because of physical differences. seals other wines with artificial corks. Again, there can be physical and cost differences between the artificial corks. also produces wines that are sealed with screw-caps.

bottles certain wines with and without the bottle seal wax. sells each of its different wines with its own distinct label. Label costs can also differ due to physical variations. The same is true for packaging costs. While some wine bottles are grouped into a case and shrink-wrapped together, other wine bottles are individually boxed. even sells some wine in flexible non-glass containers.

Production costs also include labor and overhead costs added to get the bulk wine from the aging vessel to the packaged bottle. These costs can also differ depending on the particular wine in question. For FIFO purposes, proportionately allocates current year packaging and overhead costs to all case goods that it bottled during the year but does not allocate production costs to specific wines. In its Case Goods Inventory FIFO schedule and Case Goods Inventory FIFO schedule, categorizes inventory as follows: Red Wines, White Wines, and Purchased Product.

's is a listing reflecting every cased wine product in inventory. This report lists the item number of each stock keeping unit ("SKU"), the product description, storage location, and the quantity on hand. This report does not reflect the product cost. stated that, "[T]he company does not have a report, listing, or schedule providing a detail listing of case goods inventory on a per unit (SKU) basis both by standard cost and quantity as of and ."

sells the various wines it produces at a wide array of prices. sells many wines for less than \$ per bottle (or its equivalent). also sells high end wines for nearly \$ per bottle. While information provided to date indicates that the majority of 's production is sold at prices between \$ and \$ , claims that the vast majority of its sales are in the \$ bottle to \$ bottle price category. For LIFO purposes, treats all wines sold as having the same cost per gallon. Inflation on case goods is measured by

comparing the current cost per gallon for case goods to the base cost per gallon for case goods.

is unable to provide a listing, including cost and quantity, of the different cased wines in the base inventory. It was also unable to provide a listing, including cost and quantity, of the different cased wines for the taxable years. According to it does not keep its "inventory accounting for bulk wine or case goods by vintage and varietal." The Service requested the following information on eight wines listed in 's reports and eight wines listed in 's reports.

1. Grape growing costs (vineyard maintenance costs, equipment costs, irrigation costs, labor, parts, supplies, overhead, etc.);
2. Method of harvest (manual or automated);
3. Cost of harvest (labor, equipment costs, etc.);
4. Purchased grape or purchased bulk wine costs;
5. Crush costs (labor, crush, equipment, utilities, etc.);
6. Fermentation costs (labor, additives, utilities, etc.);
7. Amount of time wine was stored in tanks; and
8. Bottling costs (equipment cost, labor, utilities, etc).

For each of these questions, answered that its accounting records were not capable of supplying such information by product. provided information on the type and cost of bottles, corks, labels, and capsules used for the identified wines. When asked to provide the same information for each of the wines included in 's base year inventory, stated, "Such information is not contained in the Company's accounting or tax records." The Service also asked to provide the aging cycles for the various wines produced by during the tax years ending and . replied that

Barrel aging varies due to a number of factors such as varietal, quality of wine, production schedules and sales requirements. The current aging cycle in barrel is the following:

On average , and wines are typically aged six months or less.

On average , and are aged twelve months or less.

A small percentage of upper tier red wines (e.g. and wines) produced at substantially smaller quantities (less than % of total sales) than the Company's main product line may be aged longer.

## LAW AND ANALYSIS

In order for [redacted]'s index computation to meet the requirements of the applicable Treasury Regulations, [redacted]'s LIFO method must clearly reflect its income. Treas. Reg. section 1.472-8(a). By using bulk wine and case goods as the only two items in its inventory pool, [redacted] fails to determine correctly its LIFO index under the regulations. Consequently, [redacted]'s LIFO index does not accurately measure inflation, and [redacted]'s LIFO method does not clearly reflect income. In this analysis, we first discuss the definition of the words "item" and "goods" in the context of I.R.C. section 472 and then the importance of a taxpayer using properly defined items to calculate the LIFO index. We then explain how [redacted]'s LIFO methodology creates a distortion due to [redacted]'s broad definition of its items.

### A. Definition of the Terms "Item" and "Goods"

Neither the Code nor the Regulations set forth a definition of the words "goods" and "items". Treas. Reg. section 1.472-8, however, seems to use the terms "goods" and "items" interchangeably when describing the dollar-value LIFO method. Treas. Reg. section 1.472-8(a) provides that "goods contained in the inventory are grouped into a pool or pools." Treas. Reg. 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." Treas. Reg. section 1.472-8(e)(2)(i) also refers to "items" contained 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 I.R.C. section 472. The Tax Court stated, "[a] narrow definition of an item within a pool will generally lead 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 items because of their cost).

's defined LIFO items, bulk wine and case goods, represent broad item definitions rather than the narrow item definition referred to by the Tax Court. does not subdivide its LIFO items into red wine, white wine and purchased wine as it does in some of its FIFO calculations. Therefore, the Service believes that 's more expensive wines are replacing its cheaper brands and distorting 's LIFO index.

#### B. Importance of Defining Item Properly

Proper item definition is the foundation on which an accurate, reliable, and suitable LIFO index must be built. The LIFO index is defined as the ratio of the current cost of the goods in inventory to the base cost of those same goods. See Treas. Reg. section 1.472-8. Since a LIFO reserve measures cumulative inflation in the ending inventory, it is imperative that the LIFO index accurately measure inflation. The Tax Court recognized the importance of defining 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 (emphasis added). 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 that

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 into 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. Like the taxpayers in Amity Leather and Hamilton, has not properly defined its items. As explained below, how defines its items creates distortions in its LIFO method and fails to properly reflect income.

### C. s Approach Creates a Distortion

If inflation is to be correctly and consistently measured, the cost differences associated with 's various wines must be identified and measured at the item level. 's inflation computation, based on summary information at the case goods and the bulk wine levels, allows product mix variations to intermingle with actual inflation elements thereby rendering an accurate index computation impossible.

produces a significant number of wines with different cost characteristics. Differences can include different costs for the different grapes used in production, different costs due to different locations where grapes used were grown, different bottle costs, different label costs, different aging costs for different wines, different bottle seals or corks, and different packaging. 's LIFO method, however, does not identify these cost differences at the item level, and does not identify these costs in its FIFO calculations. Instead, summarizes all costs into either case goods or bulk wine and makes no attempt to identify individual stock keeping units within the inventory.

The problems with this approach are shown by the following example. Assume produces a for \$10 per bottle in 2002 and for \$11 per bottle in 2003. Assume further that produces a for \$30 per bottle in 2002 and \$33 per bottle in 2003. Clearly, both bottles incurred 10% inflation from 2002 to 2003.

However, if [redacted] had two bottles of [redacted] and one bottle of [redacted] in 2002, and one bottle of [redacted] and two bottles of [redacted] in 2003, [redacted] would compute the inflation for the period as follows:

2002 average cost of wine:  $(2 @ \$10) + (1 @ \$30) = \$16.67$  per bottle

2003 average cost of wine:  $(1 @ \$11) + (2 @ \$33) = \$25.67$  per bottle

LIFO Index =  $\$25.67 / \$16.67 = 1.54\%$

Inflation = 54%

This basic example highlights a fundamental flaw with [redacted]'s LIFO method and shows that [redacted]'s methodology does not result in a clear reflection of income. Although the bias in such a methodology can work both to underestimate inflation and to overestimate inflation, it should be noted that [redacted]'s cumulative index of inflation at [redacted] is [redacted], while the Bureau of Labor Statistics ("BLS") reports inflation for grape table wines of only [redacted] for the same period. [redacted]'s inflation is almost triple the BLS inflation. Although certainly not conclusive on its own, such an extreme difference is a strong indicator that an improper item definition has worked to [redacted]'s benefit.

A more accurate measurement or example of the flaws in [redacted]'s methodology is not possible due to the fact that [redacted] does not maintain records that show costs on a narrower basis, such as by varietal. A best estimate of the degree of inaccuracy resulting from [redacted]'s broad item definition indicates that the error is extremely significant. A computation based on the BLS indexes for grape table wines (which is what [redacted] produces) results in a LIFO value of [redacted]'s inventory of \$ [redacted] rather than the \$ [redacted] as reported by [redacted]. The difference is \$52,879,657. For [redacted], the computation results in a LIFO value of [redacted]'s inventory of \$ [redacted] rather than the \$ [redacted] as reported by [redacted]. The difference is \$81,460,825. The difference of \$52,879,657 for the [redacted] tax year and the difference of \$81,460,825 for the [redacted] tax year plainly show just how extraordinarily inaccurate [redacted]'s inflation measurement has become.

Finally, [redacted]'s definitions of the two items in its inventory, bulk wine and cased wine, bears some resemblance to the taxpayer's definition of items in Richardson v. Commissioner, T.C. Memo 1996-368. In Richardson, the taxpayer operated a franchised automobile and truck dealership. In making its LIFO calculations, the taxpayer separated its cars into items based on body size but then later defined its inventory items by model line without filing an application for change in accounting method. The Service successfully argued that the taxpayer had made an unauthorized change of accounting and that the taxpayer should define its items by using a model code. In addressing the definition of item, the Tax Court found that if goods have substantially dissimilar characteristics, whether in terms of their physical nature or whether in terms of cost, the goods are properly treated as separate items for purposes of the LIFO pool. *Id.* The Tax Court analyzed how changing the item of inventory impacted the taxpayer's base-year cost and found that the model code was the appropriate approach as it more accurately

reflected the taxpayer's base-year cost. Id. Like the taxpayer in Richardson, 's overly broad definition of items causes distortions in its application of the LIFO method.

The Tax Court in Hamilton stated, "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, 97 T.C. at 128. In this case, the Service has determined that, with its overly broad definition of items, has failed to determine properly its LIFO index, and, thus, its LIFO method does not properly reflect income.

### CONCLUSION

We conclude that , with its overly broad definition of items, has failed to determine properly its LIFO index in accordance with section 472 and the case law. Consequently, because 's LIFO method does not comply with Treas. Reg. section 1.472-8, its LIFO method does not clearly reflect income. The next step will be to consider whether the Service should seek to terminate 's LIFO method. We suggest that the Service examine 's records to confirm that placing on an alternative inventory method, such as FIFO, will clearly reflect 's income.

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 (415) 227-5143 if you have any further questions.

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