APPEALS

INDUSTRY SPECIALIZATION PROGRAM

SETTLEMENT GUIDELINES

INDUSTRY: All Industries

ISSUE: Dollar-Value LIFO
Bargain Purchase Inventory

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EFFECTIVE DATE: SEP - 1 1998

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SETTLEMENT GUIDELINE

Dollar-Value LIFO Bargain Purchase Inventory

Effective Date: SEP 1 1998

ISSUES

1. Whether goods purchased in bulk at discounted amounts (bargain purchase inventory) are separate items from goods purchased or produced subsequently for purposes of calculating the value of the taxpayer's inventory under the dollar-value LIFO method authorized by Treas. Reg. Sec. 1.472-8.

2. Whether the change in the definition of an inventory item involving bargain purchase inventory is a change in a method of accounting within the meaning of I.R.C. Sec. 446 and the regulations thereunder, subject to the provisions of I.R.C. Sec. 481.

3. If the inventories purchased at discount constitute separate items, whether the taxpayer has the burden of proof to demonstrate with inventory records that such items were on hand at the end of the year.

EXAMINATION DIVISION POSITION

ISSUE 1: Inventories purchased in bulk at discounted amounts may be separate items from goods purchased or produced subsequently for purposes of calculating the value of the taxpayer's inventory under the dollar-value LIFO method authorized by Treas. Reg. Sec. 1.472-8. The significance or materiality of the discount is a question of fact to be determined on a case by case basis.

ISSUE 2: Any change in the definition of an inventory item involving bargain purchase inventory is a change in a method of accounting within the meaning of I.R.C. Sec. 446 and the regulations thereunder, subject to the provisions of I.R.C. Sec. 481.

ISSUE 3: The taxpayer has the burden of proving that the specific inventory items purchased at discount were on hand at the end of the year.

BACKGROUND

These coordinated issues of the Examination Industry Specialization Program (ISP), as framed above, were approved by the Assistant Commissioner (Examination) in September of 1995. These issues were developed by the National Examination Inventory Issue Specialist. These issues are coordinated generically for all industries.

A bargain purchase occurs when a taxpayer acquires a bulk quantity of inventory at a price significantly lower than the normal cost of production or purchase. Many times this occurs during the course of acquisition of another business in total or part [1]. If a taxpayer who has made a bargain purchase has elected the LIFO method of valuing inventories (or later elects LIFO), the taxpayer may attempt to retain the cost of those bargain purchase items in the end of year inventory whether or not such items are physically present. By retaining these lower cost items in ending inventory, the taxpayer is able to earlier pass higher cost inventory through its cost of goods sold, thereby deferring income. The taxpayer may also obtain a benefit in valuing subsequent LIFO layers. Whenever bargain cost inventory is used to establish base-year costs, artificial inflation is created. This serves to understate subsequent layers by increasing the inflation index. Any understatement of these layers translates into higher cost of goods sold.

The taxpayer's position will generally be that, because the bargain purchase inventory items are physically similar (or even identical) to inventory items it has produced or purchased after the bargain purchase, the bargain purchase items need not be distinguished for LIFO purposes. The government's position, to the contrary, is that the difference in cost alone requires the bargain purchase items to be distinguished from other items for LIFO purposes in order to clearly reflect income since the LIFO rules were intended only to counteract the effects of true economic inflation. Hamilton Industries. Inc. v. Commissioner, 97 T.C. 120 (1991).

Generally, taxpayers acquiring bargain purchase inventory who wish to defer income in the manner described above will organize a new corporation to acquire the

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[1] Non-bargain inventory with a relatively low carryover basis received by a taxpayer in a section 351 transfer which is physically identical to higher cost inventory subsequently purchased by the taxpayer does not have to be treated as a separate item by virtue of the transfer. However, if the transferred inventory is itself tainted with separate bargain purchase inventory items, this taint will remain.

inventory from the seller. If possible, the new corporation will adopt a tax year that ends shortly after the date of the acquisition to ensure that all or most of the inventory purchased at bargain prices will be physically present and included in the LIFO valuation of ending inventory for the first year (base year)[2]. The new corporation will then adopt the dollar-value LIFO method by filing a Form 970 with its return for its first taxable year. By making a LIFO election in the first taxable year and electing to use the earliest acquisition cost method to value increments, the taxpayer will attempt to value its entire base-year inventory at bargain cost. The use of bargain cost as base-year cost will ensure lower ending inventory values for subsequent years under the required LIFO index calculations. These lower ending inventory values will translate to higher deductions for cost of sales.

In scrutinizing whether the taxpayer should be allowed to use bargain costs as base-year costs, rare or occasional bargain purchases should receive greater scrutiny than regular or routine purchases by the taxpayer on favorable terms. For example, a rare bargain inventory purchase at a bankruptcy sale is more suspect than a more routine purchase on favorable terms.

LEGAL DISCUSSION

I.R.C. Sec. 472(a) provides that a taxpayer may elect to use a LIFO inventory method consistent with applicable regulations. I.R.C. Sec. 472(b)(1) provides that under the LIFO method goods comprising ending inventory are treated as first being those included in the opening inventory of the taxable year (in order of acquisition) to the extent thereof; and second, those acquired in the taxable year.
I.R.C. Sec. 472(b)(2) provides that in inventorying goods under the LIFO method, the taxpayer shall inventory them at cost. Treas. Reg. Sec. 1.472-3(d) provides that the propriety of all computations incidental to the use of the LIFO method will be determined by the Commissioner in connection with the examination of the taxpayer's income tax returns.

Treas. Reg. Sec. 1.472 -8 prescribes the operating rules for the use of the so-called "dollar-value" LIFO method of pricing inventories. Treas. Reg. Sec. 1.472-8(e)(1) is the basic provision outlining the use of the double-extension, the index, and the link-chain methods of pricing LIFO inventories. Among other things, this section states that the appropriateness of the index and the accuracy, reliability, and

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[2] Another method used by newly formed corporations involves an attempt to characterize the initial bargain cost inventory as opening inventory for the first taxable period. This is not permissible. See Rev. Rul. 85-172, 1985-2 C.B. 151.

and the link-chain methods of pricing LIFO inventories. Among other things, this section states that the appropriateness of the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns.

Treas. Reg. Sec. 1.472 -8(e)(2) prescribes the operating rules for the use of the double-extension method. Under this method, the quantity of each item in the inventory pool at the close of the taxable year is extended at both base-year unit cost and current-year unit cost. The regulations include examples illustrating how LIFO inventories should be computed under the double-extension method. Although there are no examples or other regulations that relate specifically to the use of the index or link-chain methods, it is generally agreed that the index and link-chain methods are conceptually comparable to the double-extension method.

The treatment of inventories for tax purposes is governed by I.R.C. Sections 446 and 471. These sections grant the Commissioner broad discretion in matters of inventory accounting and grant latitude to adjust a taxpayer's method of accounting for inventory so as to clearly reflect income. Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979). The Commissioner's determination with respect to the clear reflection of income is given 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.

Once the Commissioner determines that a taxpayer's method of accounting does not clearly reflect income, the Commissioner may select for the taxpayer a method which clearly reflects income. The taxpayer has the burden of showing that the method selected by the Commissioner is incorrect, and such burden is extremely difficult to carry. Photo-Sonics. Inc. v. Commissioner, 357 F.2d 656 (9th Cir. 1966). The Commissioner's determination as to the proper method of accounting for inventory must be upheld unless shown to be arbitrary. Lucas v. Kansas City Structural Steel Company, 281 U.S. 264 (1930); Ford Motor Company v. Commissioner, 71 F.3d 209 (6th Cir. 1995); E. W. Richardson v. Commissioner, T.C. Memo. 1996-368 (involving LIFO).

Treas. Reg. Sec. 1.446 -1 (e)(2)(ii)(a) provides, in part, that "a change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan." A "material item" is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. The regulation further states "changes in method of accounting include a change...involving the method or basis used in the valuation of inventories." See I.R.C. Sec. 471 and Sec. 472 and the regulations thereunder.

I.R.C. Sec. 481 (a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is computed under a method different from the method used to compute taxable income for the preceding taxable year.

The Tax Court stated in Hamilton Industries, Inc. v. Commissioner, 97 T.C. 120 (1991) that a change in the method of valuing closing inventory constitutes a change in the method of accounting to which section 481 applies. In addition, the court held that if adjustments affect the timing of the inclusion of income deferred by the taxpayer, those adjustments constitute a change in the method of accounting. See also Kohler Co. and Subsidiaries v. U.S., 34 Fed. CI. 379 (1995), .aff'd, 1997 U.S. App. LEXIS 2511 (Fed. Cir. Sept. 17, 1997).

ISSUE 1: This issue involves the bargain purchase of inventory and the subsequent use of those bargain costs as base-year costs in the computation of the value of the LIFO inventory. The issue usually arises because the acquiring corporation fails to account for the items purchased at the bargain price separately from other items routinely purchased or manufactured. The Hamilton case deals with a taxpayer that had made two bargain purchases in prior tax y ears. The discounts were 96 percent and 60 percent of the value of the inventory in the hands of the seller. In Kohler, supra, the bulk purchase of the taxpayer constituted their entire opening inventory and was obtained at approximately a 50 percent discount.

Separate item accounting is distinguished from separate pool accounting (although, in this context, there is no practical difference). See UFE, Inc. v. Commissioner, 92 T.C. 1314 (1989), where the court declined to accept the Commissioner's argument that a separate resale pool was required to account for bargain purchased finished goods inventory held for resale that was acquired in the context of the acquisition of an ongoing manufacturing business, even though Treas. Reg. Sec. 1.472-8(b)(2)(I) provides that separate pools are required for manufacturing and resale operations. Service personnel need not argue for the establishment of separate pools in this context since separate item accounting is sufficient to segregate the bargain cost inventory. The "items" issue pertains to inventory within the respective pool(s).

As stated above, the two bargain discounts in Hamilton were 96 percent and 60 percent. The Kohler bulk bargain discount was approximately 50%. The Hamilton court looked closely at its earlier opinion in Amity Leather Products v. Commissioner, 82 T.C. 726 (1984), because it was the only case which dealt with the meaning of the term "item" pertaining to manufacturers that use the dollar-value method under the regulations. In ~, the court stated that "because the change in the price of an item determines the price index and the index affects the computation of increments and decrements in the LIFO inventory, the definition and scope of an item are extremely important to the clear reflection of income." The Amity court further stated that if factors other than inflation enter into the cost of inventory items, a reliable index cannot be computed.

The Tax Court in Hamilton determined that if the taxpayer were permitted to combine the bargain cost inventory with goods carried at higher cost, representing the current cost of production, the taxpayer could postpone recognition of the gain realized on disposal of the bargain cost inventory until such time as it decided to permit liquidation of the base layer of inventory. The Tax Court held that, in order to clearly reflect income, the taxpayer should be required to recognize the gain inherent in the bargain cost inventory at the time such gain is realized, rather than at a later time of the taxpayer's choosing. 97 T.C. at 138.

Hamilton requires that the gain be recognized when the bargain purchased goods are sold. Thus, separate item accounting (perhaps by physical segregation or by other means of specific identification) is required. When these actual bargain cost units are sold, the low costs associated with these units will flow through cost of goods sold and will no longer be included in inventory. More importantly, these bargain costs will no longer be used as base-year costs for the purpose of the LIFO index computations. Thus, future LIFO calculations will more accurately reflect true economic inflation.

Nevertheless, the court in Hamilton recognized that not every purchase of inventory at a discount will require the creation of new items. Occasional purchases concluded on advantageous terms are to be expected in the course of normal business activity. An example of this type of purchase would be a volume discount obtained by the purchaser and offered in the normal course of business by the seller. However, these purchases differ materially from the case where a taxpayer attempts to value its entire base-year inventory at bargain cost, as in Hamilton and Kohler.

The Hamilton court concluded that the bargain purchase inventory had to be treated as items separate from the inventory acquired or produced subsequent to such acquisitions. Such treatment avoids a distortion of the taxpayer's income, and results in a clear reflection of income. The court ruled that the discounted items were different from other items purchased subsequently, even though physically identical, because the costs were very different. Therefore, to clearly reflect income, separate tracking of the bargain cost items was required. *See also*, Kohler, supra.

ISSUE 2: Treas. Reg. Sec. 1.446-1 (a)(1) provides that the term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. See also, Treas. Reg. Sec. 1.446-1 (e)(2)(ii)(a). In Hamilton, the Tax Court stated that a change in the method of valuing closing inventory constitutes a change in method of accounting to which section 481 applies. See 97 T.C. at 126. The Hamilton court held that the Commissioner's adjustments, which reflected the necessity of separate item accounting for bargain purchase inventory, constituted a change in method of accounting. l.Q. at 127. A similar result was reached in the more recent Kohler case. The taxpayer in Kohler also argued that certain years were closed for adjustment under the statute of limitations or "time barred." The lower court in Kohler observed, "section 481 would be virtually useless if it did not affect closed years." See also, Graff Chevrolet Company v. Campbell, 343 F.2d 568 (5th Cir. 1965).

Announcement 91-173, 1991-47 I.R.B. 29, provides that the Service will require taxpayers to compute and take a net section 481 (a) adjustment into account for a change in method of accounting relating to certain bulk purchases of inventory under the holding in Hamilton. Revenue Procedure 97-27, 1997-1 C.B. 680 at Section 5.02(3) does not allow "cut-off' for bulk bargain purchases of inventory -"Hamilton" type issues. The best relief the taxpayer can obtain is to file a Form 3115, Application for Change in Accounting Method, prior to contact for examination. This will allow a current year change and a spread forward of the I.R.C. Section 481 (a) adjustment in accordance with Rev. Proc. 97-27. However, if the change is made by the district director as part of an examination the change in method of accounting and the resulting I.R.C. Section 481(a) adjustment will be made in the earliest taxable year under examination with no spread forward of the adjustment.

ISSUE 3: The Tax Court in Hamilton discussed the nature of inventory on hand at the close of a tax year. The court agreed with the Commissioner's determination that in a situation where a taxpayer purchases a bulk quantity of inventory at a discounted rate during the year and then manufactures or purchases similar inventory, the quantities on hand are assumed to be the quantities subsequently manufactured or purchased unless the taxpayer can show specifically that some or all of the items remain from the bulk purchase.

After the Hamilton court decided that the discounted inventory acquired through acquisitions were separate items of inventory, the court addressed the question of the burden of proving whether the bargain cost items actually remained in the closing inventory. The court was not persuaded by the taxpayer's claim that separate accounting for the different items imposed an undue burden. The court stated "we find that eliminating the significant distortion in the petitioner's income which resulted from combining the two types of inventory warrants the burden that might be imposed on the petitioner."

The Service treated all of Hamilton's inventory acquired at discount as having been sold in the first full taxable year following the acquisition. This caused Hamilton to recognize the full amount of the gain from the bargain purchase in that year. Hamilton argued that not all of the inventory may have been sold in such year. The court ruled, however, that petitioner "must do more than suggest that respondent's method is less than perfect in order to carry its burden; rather, petitioner must show respondent's action to be arbitrary." 97 T.C. at 140. Hamilton maintained no records to show the period over which the bargain purchase inventory actually was liquidated. The court did not accept Hamilton's argument.

SETTLEMENT GUIDELINES

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SETTLEMENT APPROVAL

Not all fact situations can be covered in a guideline such as this. Different factual situations or variations may arise that cause the above guidelines to be inappropriate for your case. IRM 8760 explains the approval procedures for appeals officers and team chiefs. Delegation Order 247 requires examination case managers to obtain the approval from both Exam and Appeals ISP specialists.

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