INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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District Director
Michigan District

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:

LEGEND:

T =

a =

b =

ISSUE:

For purposes of its last-in, first-out (LIFO) inventory method, should T treat the sale of the a that was made in conjunction with the sale of its storage facilities differently than it treats sales of a made in the ordinary course of business, such that the a sold in conjunction with the sale of the storage facilities is removed from inventory as a so-called "vertical slice"?

CONCLUSION:

Under the circumstances described below, for purposes of its LIFO inventory method, T should not treat the sale of the a that was made in conjunction with the sale of its storage facilities differently than it treats sales of a made in the ordinary course of business. Therefore, the a sold in conjunction with the sale of the storage facilities should not be removed from inventory as a so-called "vertical slice".

FACTS:

T is engaged in the business of selling and storing a. T uses the specific goods LIFO inventory method to account for its inventory of a.

In b, T sold 23 percent of its a inventory in conjunction with the sale of storage facilities that it considered represented excess capacity. T's opening inventory of a in b was 149x units and its closing inventory was 115x units. T treated the a remaining on hand at the close of the year as those included in the opening inventory in b in the order of acquisition. In so doing, T treated the sale of the a that was made in conjunction with the sale of the storage facilities the same as it treated its sales of a made in the ordinary course of business.

LAW AND ANALYSIS:

Section 446(b) of the Internal Revenue Code provides that, if the method of accounting used by the taxpayer does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Section 1.446-1(c)(1)(ii)(C) of the Income Tax Regulations provides that no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. The method used by the taxpayer in determining when income is to be accounted for will generally be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations.

Section 472(a) provides that a taxpayer may use the LIFO inventory valuation method in inventorying goods specified in an application to use such method. The change to, and 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.

Section 472(b)(1) provides that under the LIFO inventory method the taxpayer shall treat the goods remaining on hand at the close of the taxable year as first being those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof and second, those acquired in the taxable year.

Section 1.472-1(a) provides that under the LIFO inventory method, the taxpayer is permitted to treat those goods remaining on hand at the close of the taxable year as being: (1) Those included in the opening inventory of the taxable year, in the order of acquisition and to the extent thereof, and (2) Those acquired during the taxable year.

In Hamilton Industries v. Commissioner, 97 T.C. 120, 128 (1991), the court held that a taxpayer's inventory valuation method is subject to the requirement under § 446(b) that it clearly reflect income, and that, for tax purposes, the clear reflection requirement is paramount.

In treating the 115x units of a remaining on hand at the close of b as those included in the opening inventory in the order of acquisition, T was accounting for its inventory of a in accordance with §§ 472(b)(1) and 1.472-1(a). The examining agent, however, argues that the sale of the a that was made in conjunction with the sale of the storage facilities was not a sale of inventory because it was not a sale made in the ordinary course of business. The examining agent, therefore, concludes that §§ 472(b)(1) and 1.472-1(a) are inapplicable.

The examining agent argues that T was required to remove the a that was sold in conjunction with the sale of the storage facilities from its inventory prior to the sale. The examining agent further argues that the a is required to be removed as if T were separating an existing LIFO pool into two or more pools.[1] Therefore, the examining agent argues, to clearly reflect income, T must remove the a from its inventory pro rata from the base year units and the subsequent yearly units of increment, removing the a as a so-called "vertical slice."

The examining agent's rationale for removing the a from inventory as a vertical slice is that the bulk sale of a in this case represents a contraction of T's business, and that sales occasioned by a decision to reduce the level of operations or investment in inventory should be treated differently than sales occurring in the ordinary course of business. The agent states that the LIFO inventory method is predicated on the theory that the operations of a business require that a certain level of inventory be maintained throughout the life of the enterprise and that the increasing costs associated with maintaining the level of inventory should be expensed during the year incurred. However, in the situation of sales occasioned by a decision to reduce the level of operations or investment in inventory, exclusion from taxable income of the current cost associated with maintaining inventory levels is not a concern because the taxpayer does not contemplate replacement. Rather, the examining

[1]Under § 1.472-8(g)(2), when a taxpayer separates a dollar-value LIFO inventory pool into two or more pools, the taxpayer is required to separate the LIFO value of his inventory for the base year and each yearly layer of increment.

agent argues, because the taxpayer has decided to reduce its investment in inventory the taxpayer should remove from inventory the historical cost of acquiring the inventory thereby recognizing the inventory profits previously deferred.

We disagree with the examining agent's conclusions. First, we believe that the a that was sold in conjunction with the sale of the storage facilities was inventory. The fact that T ultimately sold the a in bulk in connection with the sale of the storage facilities does not alter that fact. See Grace Bros., Inc. v. Commissioner, 10 T.C. 158 (1948), aff'd, 173 F.2d 170 (9th Cir. 1949); Lawrie v. Commissioner, 36 T.C. 1117 (1961); Martin v. United States, 330 F. Supp. 681 (M.D.Ga. 1971).

Second, even if the LIFO inventory method is predicated on the theory that the operations of a business require that a certain level of inventory be maintained throughout the life of the enterprise as the examining agent argues, we do not believe that the level necessarily is static. We believe that the required level of inventory could change with the growth or decline of a business. The LIFO inventory method provides, through the use of increments and decrements, a methodology that appropriately accounts for the cost of inventory added or removed as a result of a growth or decline in the business. We believe that this methodology, which requires removing units in reverse chronological order, is consistent with removing from inventory the historical cost of acquiring the inventory when a taxpayer decides to reduce its inventory level.

For example, assume that a taxpayer using the specific goods LIFO inventory method has an inventory in Year 1 of 100 widgets, that in each of the years 2 through 10 the inventory of widgets increases by 10, and that in Year 11 the taxpayer decides to reduce its inventory of widgets by 50. Under these facts, we do not believe that there is any reason to conclude that the taxpayer is eliminating from inventory a pro rata portion of its base year widgets. In fact, in year 11, the taxpayer's inventory of widgets numbers 140, 40 more than the taxpayer had in the base year. We believe that the LIFO inventory methodology contemplates that the taxpayer in this example is eliminating the widgets that were incrementally added in Years 6 through 10.

As a general matter, we do not believe that, for purposes of the LIFO inventory method, bulk sales of inventory should be treated differently than sales made in the ordinary course of business.[2] Under the facts of this case, we do not believe that the a sold in conjunction with the sale of the storage facilities should be removed from inventory as a so-called "vertical slice." Instead, we believe that T's treatment of the sale of the a that was made in conjunction with the sale of the storage facilities, which was the same as its treatment of sales of a made in the ordinary course of business, clearly reflects T's income.

CAVEAT:

A copy of the Technical Advice Memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

[2] This situation differs from the situation in Rev. Rul. 85-176, 1985-2 C.B. 159, where it was held that a corporation that uses the dollar-value LIFO inventory method and transfers a portion of its inventories in a nontaxable exchange under § 351 must compute its basis in the inventories transferred using a pro rata (vertical) division of the base year and subsequent yearly incremental costs. Rev. Rul. 85-176 stated that any other method would inappropriately treat the nontaxable transaction as if it were another sale of goods out of inventory.