Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: October 22, 2004

to: William Henck, Senior Attorney
(CC:LM:MCT:WAS:RCH)

from: Grant Anderson, Senior Counsel
(CC:ITA:7)

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subject: Farm Price Method of Inventory

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

LEGEND

Taxpayer	=
Animals raised for sale or slaughter	=
Animals	=
A	=
B	=
C	=
D	=
E	=
F	=
G	=
H	=
J	=
K	=
L	=
M	=
N	=
X	=

ISSUES

Whether Taxpayer's method of valuing animals raised for sale or slaughter under the farm price method complies with the requirement of the Consent Agreement that the valuation of such animals should reflect, on some reasonable basis (such as weight), the fact that the market price of such animals accrues ratably as the animals mature.

CONCLUSIONS

Taxpayer's method of valuing animals raised for sale or slaughter does not reasonably reflect the ratable accrual of market value as such animals mature.

FACTS

Taxpayer is a vertically integrated producer, processor, marketer and distributor of fresh and processed animal products. Taxpayer is also a processor and merchandiser of grain, feed ingredients and other related products.

Taxpayer maintains inventories of live animals (including H) using the lower of cost or market method as described in § 1.471-4 of the Income Tax Regulations. Separate inventories are maintained for supplies and raw materials, and for processed animal and food products.

The taxpayer filed a Form 3115, Application for Change in Accounting Method, requesting permission to change its method of inventory accounting for live animals to the farm price method under § 1.471-6(d) for the taxable year X (year of change). The Office of the Associate Chief Counsel (Income Tax and Accounting) issued a "Consent Agreement," which specified that the taxpayer would value inventories of live animals under the farm price method, as described in section 1.471-6, by using market price less direct cost of disposition. Alternatively, the taxpayer could elect to account for livestock under the unit livestock method of accounting.

After providing a means for determining the market price of H and breeder animals, the agreement permitted the taxpayer to "determine the market price for animals raised for sale or slaughter in a manner that reflects, on some reasonable basis (such as weight), the fact that the market price of an animal raised for sale or slaughter accrues ratably as the animal raised for sale or slaughter matures." The agreement required the taxpayer to revise its previously submitted § 481(a) adjustment to reflect a proper valuation of live animal inventories consistent with the principles in the agreement. The director would then ascertain whether the amount of the revised § 481(a) adjustment was properly determined.

You are now considering the taxpayer's revised § 481(a) calculation.

LAW AND ANALYSIS

The question presented is whether Taxpayer's revised method of valuing animals raised for sale or slaughter under the farm price method complies with the requirements of the Consent Agreement. Specifically, the Consent Agreement provides that Taxpayer will value animals raised for sale or slaughter in a manner that reflects, on some reasonable basis (such as weight), the fact that the market price of an animal raised for sale or slaughter accrues ratably as the animal raised for sale or slaughter matures.

In its revised § 481(a) calculations, Taxpayer values all animals within an inventory category at the same relatively low value ("J value") until the earliest date they may be sold to a meat processor; thereafter, Taxpayer makes certain adjustments to increase the value of the animals as they mature.

For example, in the inventory category of A, any animal aged between 1 day and K days is valued at $C per head, while an animal aged K+1 or K+2 days is valued at $D. In the inventory category B, any animal aged between 1 day and L days is valued at $E, any animal aged between L+1 and M days is valued at $F, and any animal aged between M+1 and N days is valued at $G.

Taxpayer's revised valuation method does make some provisions for increasing the value of animals as they mature once they have passed their first saleable date. We lack sufficient background information to opine on whether these provisions provide a reasonable reflection of the ratable accrual of market value. We believe, however, that Taxpayer's practice of assigning the same "J value" to all animals in an inventory class before their first saleable date is unreasonable on its face.

The time period before an animal is first saleable varies by inventory category, but it is a significant portion (60% to 90%) of the life cycle of the animal. Consequently, the practice of assigning the same "J value" to all animals within this time period embodies a highly counterintuitive notion of how an animal accrues market value as it matures. In the category of A, for example, this practice assigns the same value to an animal throughout 90% of its life cycle, and then increases the valuation more than 5 times between day K and day K + 1. In the category of B, animals aged P, P+10, P+20 and P+30 days are all valued at the same amount, while a P+31 day old animal is valued at more than 4 times the value of a P+30 day old animal. This notion – that an animal accrues no market value at all for much of its life until its value shoots up dramatically overnight – is patently unreasonable as a reflection of how an animal accrues market value.

Stated another way, the practice of assigning "J value" to all animals before their first saleable date follows a valuation principle different from the one required by the Consent Agreement. The "J value" practice effectively determines valuation based upon saleable stages of the animal; until the animal is in its first saleable stage, its value is constant, regardless of its relative maturity. By contrast, the Consent Agreement does not allow valuation to be determined by saleable stages; rather, the Consent

Agreement requires that the value of the animal be ratably accrued on some reasonable basis (such as weight) as the animal matures. This requires that the animals below the first saleable date be valued to reflect their differing maturities, which Taxpayer's revised valuation method does not do. Taxpayer's "J value" practice is inconsistent with the valuation principle required by the Consent Agreement.

Accordingly, we believe that taxpayer's practice of assigning "J value" to all animals in an inventory category below their first saleable date does not comply with the Consent Agreement requirement that the valuation of animals raised for sale or slaughter should reflect, on some reasonable basis (such as weight), the fact that the market price of such animals accrues ratably as the animals mature.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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) 622-4930 if you have any further questions.