OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
January 11, 1999

CC:DOM:FS:IT&A

UILC: 472.01-02; 472.08-08; 446.01-05

Number: **199920002**
Release Date: 5/21/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated October 7, 1998. 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	=
Fiscal Year 1	=
Fiscal Year 2	=
Fiscal Year 3	=
Fiscal Year 4	=
X	=
M#	=
N#	=
Date 1	=
Date 2	=

ISSUES:

1. Whether the Service may terminate Taxpayer's LIFO election in Fiscal Year 3 for failure to keep adequate records as required by Treas. Reg. §1.472-2?

2. Whether Taxpayer improperly changed its method of accounting in Fiscal Year 4 by altering its definition of “items” within its LIFO pool without the consent of the Commissioner?

3. Whether Taxpayer improperly reconstructed its base year costs for the ending inventory of its redefined “items” in Fiscal Year 4?

CONCLUSIONS:

1. The Service may terminate Taxpayer’s LIFO election if the District Director determines that Taxpayer failed to maintain sufficient accounting data to support its LIFO calculations.

2. Taxpayer changed its method of accounting when it adopted a new and more narrow definition of the “items” within its LIFO pool in Fiscal Year 4. Because Taxpayer did not secure the consent of the Commissioner, Taxpayer improperly changed its method of accounting in Fiscal Year 4.

3. Because Taxpayer improperly changed its method of accounting by altering its definition of “items” within its LIFO pool, the issue of reconstruction of those “items” is moot. However, even if the newly defined “items” were in fact new items, its reconstruction of base year costs for all the “items” (except pearls) appears unreasonable.

FACTS:

Taxpayer is an S Corporation engaged in the retail jewelry business. In Fiscal Years 3 and 4, it operated X showrooms in which it sold precious and semi-precious stones (diamonds, rubies, sapphire, emeralds), pearls, and gold, in forms such as rings, pendants, necklaces, earrings, brooches, and other jewelry. Generally, Taxpayer's inventory represents a midrange of stones and jewelry in terms of quality and price.

Precious and semiprecious stones are purchased from wholesale dealers, generally in lots. Fashion mountings are purchased from manufacturers. Each precious and semi-precious stone is weighed and graded before becoming available for sale in a showroom. Stones are transferred to the manufacturer for mounting in a fashion jewelry piece, such as a ring, pendant, or necklace, in which case it is purchased by a customer with the stone included. Alternatively, a customer may select a stone individually, or a stone and a setting, and have the stone mounted in the chosen piece of jewelry by Taxpayer's staff.

Taxpayer elected LIFO in Fiscal Year 1. Later, Taxpayer filed another election regarding the use of multiple pools. In Fiscal Year 2, Taxpayer requested a change in method of accounting for its LIFO inventory. Taxpayer received permission to use the double extension method and have a single pool. From that point through Fiscal Year 3, Taxpayer consistently used a single pool (with M# of items), with the LIFO value computed by using the double extension method. Taxpayer's LIFO inventory method was not examined by the Service until the two years in suit, Fiscal Years 3 and 4.

From Fiscal Year 2 through Fiscal Year 3, the items in Taxpayer's single pool were generally composed of finished goods inventory, such as ladies rings. However, diamonds and semi-precious stones were treated as items in the pool, with a weight classification.

Beginning with Fiscal Year 4, Taxpayer began accounting for its items in a different fashion. While there was still one pool, there were now N# of items, a ten-fold increase. The Taxpayer accounted for the cost of each piece of jewelry in ending inventory by using three component parts: the type of stone in the merchandise (diamonds, colored stones [rubies, sapphire, emeralds], and pearls), the amount of gold in the merchandise, and the difference of the first two over total costs of the merchandise (labor costs and vendor profits). Taxpayer neither submitted nor received any approval to make such changes. Taxpayer claims the changes in items is a result in a change in its product mix (i.e., different types of merchandise were added to its inventory), and thus involves a change in facts.

For about a decade from Fiscal Year 1 (until Date 1), Taxpayer's accounting records were manually prepared. It kept inventory records by item purchased, date of purchase, and cost. Invoices were received for stones. Although Taxpayer maintained its inventory records contemporaneously during the years it was on a manual system, it no longer has available the inventory listings, cards, or invoices from this period.

Beginning from Date 1, Taxpayer instituted a computerized accounting system, including an inventory function. Its inventory lines followed its prior practices. Although Taxpayer no longer has invoices from Date 1 to Fiscal Year 3, it has computerized inventory records from this period.

In addition, Taxpayer has workpapers contemporaneously prepared by Taxpayer's certified public accountants that were used in the course of preparing Taxpayer's financial statements. These consist of prepared schedules of the unit cost of ending inventory in the base year and the total cost of ending inventory in the base year. These workpapers were prepared in Fiscal Year 2, when Taxpayer was permitted to change its method of accounting and combine its historical LIFO pools into one pool and recalculate base year cost.

Because of the ten-fold increase in items within its single pool, Taxpayer had many new items entering its LIFO computations in Fiscal Year 4. Taxpayer reconstructed the cost of these new items by going back to Fiscal Year 1, the base year, and comparing to current year (Fiscal Year 4) costs. For gold and pearls, Taxpayer used third-party pricing information to create an index. For diamonds and the colored stones, an index was created using a combination of external and internal pricing information.

Taxpayer computed base-year costs for its redefined inventory of diamonds, by comparing the Fiscal Year 1 weighted average cost of diamonds to the Fiscal Year 4 weighted average cost to determine an index. From this, a base-year cost for each new item of diamonds was developed, using this index and the current year cost of each item.

The Taxpayer followed a similar procedure for colored stones. It developed a weighted average index by comparing Fiscal Year 1 prices to Fiscal Year 4 prices. With this index, base year costs for its new colored stone items was developed, based on current year costs reduced by this index.

As noted above, base year costs of pearls was determined using external pricing information from industry sources. The agent has not challenged this index.

For the second component comprising Taxpayer’s item accounting, gold, Taxpayer constructed an index using the price of gold by weight for Fiscal Year 1 and comparing it to the price of gold by weight in Fiscal Year 4. With this index, it determined the base year cost of its gold items, reducing current year (Fiscal Year 4) costs by the index.

An index for the final component, labor and vendor markup, was determined by using the Bureau of Labor Statistics Producer Price Index for jewelry from Date 2 to Fiscal Year 4. From this index, an amount was subtracted for the gold component of jewelry, using the gold index developed. The remaining amount was then used as the net labor and vendor markup index, applied to current year (Fiscal Year 4) costs to create a base year.

The agent determined that the indexes (except for pearls) could not be verified because there was insufficient information presented to repeat the Taxpayer's calculations and arrive at the same index values. The agent thus recomputed base-year cost for the new items. For diamonds, the agent relied on two industry sources that tracked the cost of diamonds, DeBeers and the Rappaport Diamond Report, to determine an index. For colored stones, the agent relied on several published industry sources tracking prices of colored stones separately. An index for emeralds, rubies and sapphire, respectively, was determined. The agent relied on published prices for refined gold in determining an index for gold, and did not include any labor/vendor margin.

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), which is an exception to that general rule, provides that if no method of accounting has been regularly used by the taxpayer, or if the method used 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.

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.

Treas. Reg. § 1.446-1(a)(1) provides, in part, that the term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item.

Treas. Reg. § 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.

Treas. Reg. § 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not include a change in treatment resulting from a change in underlying fact. However, a change in the overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Treas. Reg. § 1.446-1(e)(2)(ii)(c); Hamilton Industries, 97 T.C. at 126; Pacific Enterprises v. Commissioner, 101 T.C. 1 (1993). A change in the value of closing inventory, including a change in the treatment of "items" within a LIFO pool, constitutes a change in method of accounting. Hamilton, 97 T.C. at 126, 135-40.

Section 446(e) and Treas. Reg. § 1.446-1(e)(2)(i) state that a taxpayer which changes its method of accounting on the basis of which it keeps its books must, prior to changing to a different method, secure the consent of the Commissioner. Consent must be secured regardless of whether the method a taxpayer is changing is proper or permitted. Treas. Reg. § 1.446-1(e)(2)(2)(i); Commissioner v. O Liquidating Corp., 229 F.2d 225 (3d Cir. 1961), cert. denied, 368 U.S. 898 (1961).

Section 472 provides, in part, for the election to use the last-in, first-out (LIFO) inventory valuation system in accordance with such regulations as the Secretary may prescribe as necessary in order that the use of such method may clearly reflect income.

Treas. Reg. § 1.472-2(h) provides, in part, that supplemental and detailed inventory records shall be maintained as will enable the district director readily to verify the taxpayer's inventory computations as well as his compliance with the requirements of LIFO.

Treas. Reg. § 1.472-3(d) provides, in part, whether the use of LIFO, 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. § 1.472-5 provides, in part, that an election made to adopt and use the LIFO inventory method is irrevocable, and the method once adopted shall be used in all subsequent tax years, unless the use of another method is required by the Commissioner.
Treas. Reg. §1.472-6 provides rules for how taxpayers are to change from the LIFO inventory method when they are required by the Commissioner to discontinue the use of such method.

Treas. Reg. § 1.472-8(a) provides, in part, for the use of the dollar-value LIFO method, which gauges changes in the dollars invested in a pool. Fluctuations may occur in quantities of various items within the pool, and new items may be added and old items may disappear, but all liquidations and increments of items in the pool shall be reflected only in terms of a net liquidation or increment for the pool as a whole.

Treas. Reg. § 1.472-8(c) provides, in part, that items of inventory in the hands of retailers shall be placed into pools by major lines, types, or classes of goods. In determining such groupings, customary business classifications of the particular trade in which the taxpayer is engaged is an important consideration.

Treas. Reg. § 1.472-8(d) provides, in part, that whether the number and composition of the pools used by the taxpayer is appropriate, as well as the propriety of all computations incidental to the use of such pools, will be determined in connection with the examination of the taxpayer's income tax return. Adequate records must be maintained to support the base-year costs as well as the current-year unit cost for all items priced on the dollar-value LIFO inventory method. The pool or pools selected must be used for the year of adoption and for all subsequent years unless a change is required by the Commissioner in order to clearly reflect income.

Treas. Reg. § 1.472-8(e)(2)(iii) provides that, under the double extension method, a base-year costs must be ascertained for each item entering a pool for the first time subsequent to the beginning of the base year. In such a case, the base-year unit cost shall be the current-year cost of that item unless the taxpayer is able to reconstruct or otherwise establish a different costs. A new item not in existence on the base date may be reconstructed, by reasonable means. A cost for a new item in existence but not stocked by the taxpayer on the base date may be reconstructed using available data or records. The reconstructed cost of a new item must be established to the satisfaction of the Commissioner.

Rev. Proc. 79-23, 1979-1 C.B. 564, provides examples of situations that warrant the disallowance or termination of a LIFO election. Failure by the taxpayer to maintain adequate books and records with respect to its LIFO inventory and all supporting computations is a ground for termination. However, termination in these situations is not automatic due to the discretionary authority in section 472(e)(2) and the underlying regulations.

Rev. Proc. 79-23 also provides that termination is not warranted in some situations, specifically where the selection by the taxpayer of a fewer or greater number of inventory pools than required by an examining agent and where the use of BLS indexes in valuing LIFO inventories by a taxpayer who is not a department store are used.

LIFO termination may be appropriate where a taxpayer fails to keep detailed inventory records and fails to compute its inventory using the specific LIFO method originally elected, thus not properly developing its index percentage. Boecking v. Commissioner, T.C. Memo. 1993-497.

Recordkeeping

The taxpayer argues that the accounting workpapers it has maintained suffice to meet the record-keeping requirement described above. It argues that since the accountants had access to original books and records and used them to verify the Taxpayer's LIFO computations, they are sufficient to "verify" the LIFO computations.

The agent argues that he is unable to verify the Taxpayer's LIFO calculations and computations because of the lack of original inventory records. Specifically, the agent argues that the Taxpayer should have retained invoices to verify its inventory.

Treas. Reg. § 1.472-2(h) provides, in part, that supplemental and detailed inventory records shall be maintained as will enable the district director readily to verify the taxpayer's inventory computations as well as his compliance with the requirements of LIFO.
In Rev. Proc. 79-23, the Service announced that a failure to keep adequate books and records is grounds for termination of a taxpayer's LIFO election. What records are adequate is a case by case determination.

We believe that adequate records pertaining to LIFO calculations requires that supporting accounting data, invoices and records, should be kept as appropriate. Failure to maintain all invoices since the first year of the LIFO election is not, by itself, sufficient to terminate an election. But failure to maintain original inventory records sufficient to enable the Service to verify LIFO calculations could fail the record keeping requirement and permit termination. See Boecking v. Commissioner, T.C. Memo. 1993-497.

Unauthorized Accounting Change

The Taxpayer argues that its item definition change in Fiscal Year 4 resulted from a change in underlying facts and is therefore not an unauthorized accounting change per Treas. Reg. § 1.446-1(e)(2)(ii)(b). This change in facts was the substantial change in its product mix as it introduced less-expensive rings and diamonds into its inventory.

The agent argues there were no new items introduced into inventory, merely a change in the degree to which certain items were carried in inventory. This, the agent argues, is not a factual change related to Taxpayer's existing item definition. The agent also believes that Taxpayer's previous definition of items was overly broad, so that when it allegedly substituted less-expensive for more-expensive products, the reduction in cost appears as deflation. If Taxpayer's alleged change in mix had gone the other way, it would have appeared as inflation, to the taxpayer's advantage.

We agree with the agent. Taxpayer's change from M# of items to N# of items was not merely the result of a change in inventory mix. Taxpayer added more quantity of less-expensive jewelry vis-a-vis more-expensive jewelry, but it carried both items in Fiscal Year 4 and Fiscal Year 2, when it changed its method of accounting for LIFO inventory. Taxpayer probably chose too few items in Fiscal Year 2, but it nonetheless had to abide by its choice (and did so for some years until Fiscal Year 4). Taxpayer broke out the components of its finished products, and then broke down the quality of the gold and the quality of the diamonds, pearls, or colored stones. But it always had high-end and low-end men's rings, for example. By changing its definition of items within its pool, Taxpayer has changed the treatment of inventory, which affects the timing of income. A change in the overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Treas. Reg. § 1.446-1(e)(2)(ii)(c); Hamilton Industries v. Commissioner, 97 T.C. 120 (1991); Pacific Enterprises v. Commissioner, 101 T.C. 1 (1993).

Because this involves a change in method of accounting, Taxpayer needed the permission of the Commissioner before it could make the change. Section 446(e); Treas. Reg. § 1.446-1(e)(2)(i). Because Taxpayer failed to secure the Commissioner's consent, Taxpayer is required to continue to use M# of items within its pool, as it has since Fiscal Year 2, when consent was last secured to change its LIFO inventory.

Reconstruction of "Items" Entering its Pool in Fiscal Year 4

Because it appears that Taxpayer changed its method of accounting for items within its pool without the Commissioner's consent, Taxpayer should remain on its method as approved in Fiscal Year 2. Accordingly, Taxpayer does not have any new "items" entering its pool in Fiscal Year 4, and thus the issue of reconstruction of the new "items" is mooted.

However, assuming Taxpayer could redefine its "items" in Fiscal Year 4, then a base-year cost must be computed for each new item. Treas. Reg. §1.472-8(e)(2)(iii). The Regulations provide that the taxpayer must reconstruct such cost to the satisfaction of the Commissioner, or the taxpayer must use a subsequent year's cost or, if unavailable, current year's cost. If current year cost is used, a price index of 1 will be produced and no inflation will be eliminated from taxpayer's inventory.

While any reasonable method may be used for reconstruction, such method must satisfy the Commissioner. The agent believes that Taxpayer's base year price reconstruction was unreasonable because the results were substantially inconsistent with published industry reports and indexes. We agree with the agent that Taxpayer's reconstruction is not appropriate.

Taxpayer accounted for the cost of each piece of jewelry in ending inventory by using three component parts: the type of stone in the merchandise (diamonds, colored stones [rubies, sapphire, emeralds], and pearls), the amount of gold in the merchandise, and the difference of the first two over total costs of the merchandise (labor costs and vendor profits). We have problems with this approach. In determining an index for labor costs and vendor profits, Taxpayer used the Bureau of Labor Statistics Producer Price Index for jewelry from Date 2 to Fiscal Year 4.

From this index, an amount was subtracted for the gold component of jewelry, using the gold index developed. The remaining amount was then used as the net labor and vendor markup index, applied to current year (Fiscal Year 4) costs to create a base year. Such an index is too derivative, determined after washing out the costs of the stone and the gold in each piece of merchandise, and then being aggregated for all merchandise. As such, the index is does not appear reasonable.

As for the type of stone component, especially diamonds and colored stones, Taxpayer computed base-year costs for its redefined inventory by comparing the Fiscal Year 1 weighted average cost of diamonds and colored stones to the Fiscal Year 4 weighted average cost to determine an index. From this, a base-year cost for each new item of diamonds/colored stones was developed, using this index and the current year cost of each item.

This type of reconstruction also appears unreasonable. Taxpayer is determining an aggregate diamond index (weighted average), using prices in Fiscal Year 4 and comparing to Fiscal Year 1. From this aggregate inflation index, Taxpayer is applying that index to each type of diamond “item” in its inventory. Taxpayer must calculate a separate index for each “item” of inventory; it cannot use an aggregated index for diamonds to apply to multiple diamond “items.” Likewise, and perhaps worse, Taxpayer is apparently using an aggregate (weighted average) inflation index for colored stones, and applying them to each colored stone “item” in its inventory. An aggregate index based on costs of sapphires, rubies, and emeralds cannot be used to determine the base year cost of a specific type of emerald, or a specific type/quality of sapphire. Taxpayer must calculate a separate index for each “item” of inventory, each sapphire “item,” each ruby and emerald “item.” It cannot use an aggregated index for colored stones and apply that index to various “items” of sapphires, rubies, and emeralds.

For the second component comprising Taxpayer’s item accounting, gold, Taxpayer constructed an index using the price of gold by weight for Fiscal Year 1 and comparing it to the price of gold by weight in Fiscal Year 4. With this index, it determined the base year cost of its gold “items”, reducing current year (Fiscal Year 4) costs by the index. The agent relied on published prices for refined gold in determining an index for gold, which also appears reasonable.

Taxpayer’s reconstruction is unreasonable because, assuming its index is adequate, it is using that index for all its “items” of gold. Again, each “item” must have a specific base-year cost determined for it; using an aggregate index for individual “items” is improper.

Because Taxpayer has not established that the reconstruction of its N# of items of inventory in Fiscal Year 4 was reasonable, the new “items” entering the inventory in Fiscal Year 4 should have an index of 1.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Deborah A. Butler
Assistant Chief Counsel

By: ______________________________
GERALD M. HORAN
Senior Technician Reviewer
Associate Chief Counsel (Domestic)