INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
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CASE MIS No.: TAM-104570-99/CC:DOM:IT&A:B7

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

Taxpayer - FSC =

Commonwealth =

City =

State =

a =

b =

business =

d =

f =

h =

raw materials =

District Director,
TAM-104570-99

y =

z =

category =

sub-category =

detailed category =

production =

produce =

finished =

=

=

unit =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

Year 5 =

period =

ISSUES:

1. Whether the accounting method change consent letter granted Taxpayer permission to compute Taxpayer - FSC's commission using the joint cost accounting method described therein, or whether the "no opinion" clause in the consent letter delegated authority to the District Director to determine the appropriateness of the described joint cost accounting method for computing the amount allowable as a foreign sales corporation (FSC) commission.

2. Whether Taxpayer's method of allocating joint production costs to categorys satisfies the requirements of § 1.471-7 of the Income Tax Regulations, or whether Taxpayer's joint production costs must be further allocated among detailed categorys to satisfy the requirement of § 1.471-7 that the joint cost allocation "bear a reasonable relation to the selling values of the different kinds, sizes, or grades of product."

3. Whether § 1.471-7 requires that Taxpayer divide its export products and similar domestic products into separate categories because the disparate selling prices commanded by export and domestic products result from differences in their size, kind, or grade.

4. Whether § 1.925(a)-1T(c)(6)(iii) of the temporary regulations imposes an additional standard for the allocation of production costs. If so, whether Taxpayer's allocation method satisfies that standard.

5. Whether the accounting method change consent letter may be retroactively modified or revoked if it is determined that Taxpayer's method of allocating joint production costs does not satisfy the requirements of § 1.471-7 or § 1.925(a)-1T(c)(6)(iii).

CONCLUSIONS:

1. The accounting method change consent letter granted Taxpayer permission to allocate production costs, and consequently, to determine the amount allowable as a FSC commission using the joint cost accounting method described therein. The "no opinion" sentence in the consent letter did not authorize the District Director to determine the appropriateness of the proposed joint cost accounting method.

2. Taxpayer's method of allocating joint production costs to categorys does not satisfy the clear reflection of income standard of § 1.471-7 because it does not further allocate the costs of a category among the joint products produced from that category. However, Taxpayer is not required to allocate joint production costs among detailed categorys unless those detailed categorys are produced from a single category or sub-category as a result of a joint production process.

3. Our resolution of Issue 2 and Issue 5 obviates the need to resolve this issue.

4. For purposes of computing the combined taxable income of Taxpayer and Taxpayer - FSC on export sales, the method of accounting used by Taxpayer to determine cost of goods sold constitutes a "method of accounting of the FSC" within the meaning of § 1.925(a)-1T(c)(6)(iii)(B), and is therefore subject to the "clear reflection of income" standard in § 446(b) as well as the § 1.925(a)-1T(c)(6)(iii)(B) prohibition against "material distortion" of the income of the FSC and the related supplier. Thus, the related supplier's method of accounting must clearly reflect the income of both the

related supplier and the FSC from export transactions. In other words, the related supplier's method of accounting must accurately measure the profit on export transactions by matching the revenue from such transactions against the related costs. Taxpayer's method of accounting in this case fails to clearly reflect the income from export transactions.

5. Because Taxpayer's method of allocating joint production costs does not satisfy the requirements of § 1.471-7 and § 1.925(a)-1T(c)(6)(iii), the consent letter granting Taxpayer permission to use its joint cost accounting method is revoked. However, Taxpayer is entitled to relief under § 7805(b) because it disclosed all material facts in its Form 3115, Application for Change in Accounting Method.

FACTS:

Taxpayer, a Commonwealth corporation headquartered in City, State, produces a and b products and related products from ds and fs. Taxpayer's products are sold to retailers and wholesalers. Sales to foreign customers are handled by a wholly-owned foreign subsidiary, Taxpayer - FSC, that qualifies as a foreign sales corporation (FSC) under § 922 of the Internal Revenue Code. Taxpayer - FSC earns a commission on the sale of Taxpayer's products. Pursuant to § 921, a portion of a FSC's income is not subject to federal income taxation. The regulations under § 923 provide detailed rules for determining the amount allowable as a FSC commission. The amount allowable as a FSC commission under the regulations is determined, in part, by reference to the related supplier's (here Taxpayer's) inventory cost accounting method.

Taxpayer purchases whole ds and fs and produces them. As the ds and fs move through the plant, pieces are removed for further processing, using joint production processes[1] and/or separate production processes.[2] The standard industry classification of the basic parts of the d and f is the "category." A d has # categorys, and an f has ## categorys, but Taxpayer may produce hundreds of saleable products from a single d or f.

To produce a saleable product, Taxpayer uses joint production processes to split the ds or fs into categorys. The merchandise in some categorys is further processed using a joint production process into sub-categorys, but the merchandise in other

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[1]This Technical Advice Memorandum (TAM) uses the term "joint production process" to describe a single process that yields multiple products simultaneously.

[2]This TAM uses the term "separate production process" to describe a process that is not a joint production process.

categorys is processed into detailed categorys using separate production processes. Finally, the merchandise that is included in a sub-category is either processed into detailed categorys using exclusively separate production processes or further separated using a joint production process and finished according to specifications for a particular detailed category. In other words, a detailed category is a product that is removed from a particular category or sub-category and subjected to further joint or separate production processes. Thus, the merchandise in two detailed categorys may have been identical immediately after the last joint production process and differ only as a result of the separate production processes applied after the last joint production process.

Taxpayer purchases a whole d or f for a single price and sells the parts separately. There is no way to determine how much of the purchase price of the whole d or f is attributable to any one of the final products sold to customers. Thus, to determine the amount of profit from the sale of a particular final product, Taxpayer must allocate the single price, in some fashion, amongst the various parts.

Prior to Year 5, Taxpayer's method of determining the cost of inventory did not ascertain a unit cost of the various products produced during the year. Taxpayer's method only determined the total cost of the goods on hand at year-end and the remainder of the production costs were treated as cost of goods sold. Since Taxpayer's inventory costing method did not assign a unit cost to the various products produced and sold during the year, Taxpayer had difficulty determining the cost of export products sold during the year for purposes of computing the amount of allowable FSC commission. Taxpayer calculated combined taxable income for purposes of computing the allowable FSC commission by reference to weekly export profit and loss statements prepared for internal management purposes. These weekly reports assigned a cost to the export sales equal to the current domestic market price of the product plus incremental production and selling costs associated with export transactions.

The computation of the FSC commission was raised as an issue by the international examiner (I.E.) examining Taxpayer's Year 1 and Year 2 tax returns. The I.E. argued that the taxpayer should use a joint cost accounting method to assign production costs to its products. Taxpayer and the I.E. agreed to a settlement of the issue for Year 1 and Year 2. The parties also agreed that Taxpayer would be allowed to request permission to change its method of accounting for inventories beginning with the Year 5 taxable year.

Taxpayer filed a Form 3115, Application for Change in Accounting Method, specifically requesting to change its method of accounting for inventories to a uniform joint product costing method. On pages 9 and 10 of the memorandum filed with Taxpayer's Form 3115, the proposed method of accounting was described as follows:

In view of the shortcomings identified above that are present in Taxpayer's present costing method, Taxpayer proposes to adopt a uniform joint product costing methodology that would be applied to all of the finished products produced by Taxpayer, rather than the current hybrid approach under which different methods are used for d and f, and under which a byproduct costing methodology is used for some products but not for the majority of Taxpayer's products. In addition, the proposed methodology would arrive at periodly unit costs for each category of products that is produced, so that such costs may be used in determining the cost of goods sold for FSC and other tax purposes. Under the uniform joint product costing methodology that Taxpayer proposes to adopt, the costs of production and purchases for each business for the last period of each taxable year would be allocated among the products produced during the period by that business in proportion to the relative selling values of the products produced during the period. The selling values of the products produced would be determined on the basis of categorys, and, accordingly, costs would be allocated on the basis of categorys. This is the standard industry classification and results in an assignment of costs to the following categories of products:

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The proposed allocation procedure would result in the determination of a preliminary unit cost for each category for the production occurring during the last period of the year. Taxpayer would then increase this preliminary unit cost of each category by a percentage equal to the overall section 263A absorption ratio. This adjusted unit cost would be assigned to the quantity of the category remaining in ending inventory in order to determine the cost of the ending inventory. The same adjusted unit cost would be assigned to the quantity of the category sold during the period to determine the amount of cost of goods sold associated with sales of that category for the period. The same allocation and adjustment procedure would also be followed with respect to the first h periods of the year . . . . With respect to periods other than the last period of the year, this allocation and adjustment procedure would likewise result in the determination of an adjusted unit cost for each category for the production occurring during that period, and this unit cost would be used to determine the portion of total cost of goods sold for that period that is properly associated with sales of that category. Thus, in the case of export sales resulting in a commission to the FSC, the cost of these sales for the year would be determined by adding up the separately determined periodly costs for export sales, based on the periodly quantity and periodly unit costs of those sales, adjusted for the section 263A absorption ratio.

Under the caption "ACCOUNTING METHOD CHANGE REQUESTED," page 11 of the memorandum accompanying Taxpayer's Form 3115 described the proposed method as follows:

> Taxpayer respectfully requests your consent to change from its present method to the following joint product costing methodology to determine periodly unit costs for all of its products in both the a business and the b business for the taxable year ending Date 1. For each business, Taxpayer would allocate the total cost of production and raw material purchases for each period during the taxable year among the categorys produced during that period in proportion to the relative selling values of the categorys produced during that period. Each period's beginning and ending inventory of raw materials would be taken into account as described earlier. This allocation procedure would produce a preliminary unit cost for each category for each period during the year. The preliminary unit costs for each category would be adjusted by increasing the preliminary unit costs by the absorption ratio computed in accordance with the simplified production method pursuant to section 263A. The ending inventory cost for the year would be determined by assigning the adjusted unit costs calculated for each category for the last period of the year to the respective quantities of each category that were present in ending inventory for that year. The adjusted unit cost calculated for each category for each period would also be used to determine the portion of total cost of goods sold for that period that was associated with the sales of that category for that period. These adjusted unit costs for each category for each period would also be used to determine the costs associated with export sales for purposes of computing combined taxable income of Taxpayer and the FSC in order to calculate the amount of the allowable FSC commission.

The Internal Revenue Service issued a consent letter granting Taxpayer permission to change its method of accounting beginning with the Year 5 taxable year. The letter contained the following paragraphs:

> This refers to a letter filed on behalf of Taxpayer (the taxpayer) for permission to change its method of determining the cost of products in its a and b business for purposes of computing ending inventory, cost of goods sold, and the cost of export sales for federal income tax purposes. The change is from the taxpayer's present method (described below) to the uniform joint sales realization method . . . .

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> Under its proposed method of accounting, the taxpayer will use a uniform joint product costing methodology for all products in both businesses. Under the uniform joint product costing methodology, the costs of production and purchases for each business for the last period of each taxable year will be allocated among the products produced during the period by that business in proportion to the relative selling values of the products produced during the period. The selling values of the products produced will be determined on the basis of categorys, and, accordingly, costs will be determined on the basis of categorys. The proposed allocation procedure will result in the determination of a preliminary unit cost for each category for the production occurring during the last period of the year. The taxpayer will then increase this preliminary unit cost of each category by a percentage equal to the overall section 263A absorption ratio. This adjusted unit cost will be assigned to the quantity of the category remaining in ending inventory in order to determine the cost of the ending inventory. The same adjusted unit cost will be assigned to the quantity of the category sold during the period to determine the amount of cost of goods sold associated with sales of that category for the period.
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> The taxpayer represents that the relative sales value of products that are sold both on domestic and foreign markets will be determined based on the actual volume of sales and the actual selling prices for sales in each of these markets during the particular period. No opinion is expressed by this office on the appropriateness of this method as this is subject to determination by the District Director in connection with the examination of the taxpayer's income tax returns.

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> Based solely on the facts and representations set forth above, permission is hereby granted the taxpayer to change its method of determining the cost of products in its a and b business for purposes of computing ending inventory, cost of goods sold, and the cost of export sales (described above) to the uniform joint sales realization method, beginning with the year of change . . . .

The Service is currently examining the income tax returns filed by Taxpayer and Taxpayer - FSC for its Year 5 taxable year. The I.E. has proposed to recompute the FSC commission allowable for Taxpayer - FSC. Taxpayer produces numerous detailed categorys from a single category. According to the I.E., the joint cost accounting method used by Taxpayer effectively produces an average per unit cost for each unit of product that falls within a single category. Because the physical characteristics and selling values of the products that fall within a single category vary significantly, the I.E. believes that it is inappropriate to allocate joint production costs on the basis of categorys. The I.E. proposes to allocate Taxpayer's joint production costs on the basis of detailed categorys. This reallocation will increase the costs attributable to the more valuable products and, according to the I.E., reduce the profit on sales to foreign customers. Since the allowable FSC commission is based on profit from export sales, Taxpayer - FSC's allowable FSC commission will also be reduced.

LAW AND ANALYSIS:

Issue 1. Whether the accounting method change consent letter granted Taxpayer permission to compute Taxpayer-FSC's commission using the joint cost accounting method described therein, or whether the "no opinion" clause in the consent letter delegated authority to the District Director to determine the appropriateness of the described joint cost accounting method for computing the amount allowable as a FSC commission.

Taxpayer requested permission to change its method of accounting for joint production costs. In its Form 3115, Taxpayer indicated that it planned to use the proposed joint cost accounting method for purposes of determining the cost of ending inventory and cost of goods sold as well as the cost of export sales and the amount allowable as a FSC commission. The consent letter grants Taxpayer permission to use the proposed method of accounting to determine ending inventory, cost of goods sold, and the cost of export sales.

The I.E. believes that the amount allowable as a FSC commission may be determined on a basis different from the method of accounting used by Taxpayer to compute cost of goods sold and ending inventory. The I.E. argues that the consent letter did not approve Taxpayer's proposed method of allocating joint production costs for purposes of computing the allowable FSC commission. The I.E. believes that the "no opinion" clause was intended to allow the District Director to evaluate the propriety of Taxpayer's proposed method insofar as the method relates to the computation of the amount allowable as a FSC commission. Alternatively, the I.E. argues that the "no opinion" clause was intended to allow the District Director to evaluate the propriety of Taxpayer's proposed method of accounting.

Taxpayer argues that the amount allowable as a FSC commission is determined, in part, by reference to the related supplier's method of accounting for inventory and that the Service may not recompute the FSC commission based on a different allocation of joint production costs without first changing the related supplier's inventory accounting method. Taxpayer further argues that the "no opinion" sentence relates only to the method of determining the sales value of products that fall within a category in which products are sold both domestically and internationally. We agree with Taxpayer.

Section 925(a) and the regulations thereunder specify three alternative methods of determining the taxable income of a FSC, including two administrative pricing methods. Both FSCs that resell goods acquired from related suppliers and FSCs that act as an agent and receive a commission from related suppliers on the export transaction may elect the administrative pricing methods to allocate to the FSC a portion of the total proceeds from export sales in lieu of the sales price actually charged (subject to § 482 rules) if the FSC (or another party under contract with the FSC) performs certain economic processes. See § 925(c). Under the administrative pricing method elected by Taxpayer - FSC, the combined taxable income (CTI) method, the computation starts with the combined income of the related supplier and the FSC from export transactions. In the case of a commission FSC (such as Taxpayer - FSC), the CTI of the FSC and the related supplier consists of the gross receipts which would have been foreign trading gross receipts had the sale been made directly by the FSC, minus the related supplier's and the FSC's total costs. § 1.925(a)-1T(d)(2)(iii).[3] For these purposes, costs exclude the commission paid or payable to the FSC, but include "the related supplier's cost of goods sold and its and the FSC's noninventoriable costs . . . which relate to the gross receipts from the transaction." Id. (emphasis added). See also § 1.925(a)-1T(c)(6)(i).[4] The resulting CTI is then split, 23% to the FSC and 77% to the related supplier. § 925(a)(2); see also § 1.925(a)-1T(f), Example 6. Thus, the FSC commission determined under the CTI method is a direct function of the cost of goods sold attributable to export sales, as determined by the related supplier.

The consent letter is a letter ruling that granted Taxpayer permission to use the proposed method of accounting. Absent a clear statement that the ruling expressed no

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[3] Section 1.925(a)-1T(d)(2)(iii) provides: "The combined taxable income of a FSC and the related supplier from the transaction is the excess of the related supplier's gross receipts from the transaction which would have been foreign trading gross receipts had the sale been made by the FSC directly over the related supplier's and the FSC's total costs, excluding the commission paid or payable to the FSC, but including the related supplier's cost of goods sold and its and the FSC's non-inventoriable costs (citation omitted) which relate to the gross receipts from the transaction."

[4] "[T]he full costing combined taxable income of the FSC and its related supplier . . . is the excess of the foreign trading gross receipts of the FSC . . . over the total costs of the FSC and the related supplier including the related supplier's cost of goods sold and the FSC's noninventoriable costs . . . ." § 1.925(a)-1T(c)(6)(i) (emphasis added).

opinion on the propriety of the joint cost accounting method, we cannot conclude that the ruling merely granted Taxpayer bare consent to change its method of accounting. The “no opinion” sentence refers only to the immediately preceding sentence which addresses the method of determining the relative sales value of products that fall within a category and are sold both domestically and internationally. The “no opinion” sentence did not give the district director authority to unilaterally disallow Taxpayer’s use of the proposed method of accounting or to require Taxpayer to allocate joint production costs based on more detailed categories. Hence, the I.E. may not unilaterally change Taxpayer’s computation of the allowable FSC commission based on the “no opinion” sentence.

Issue 2. Whether Taxpayer’s method of allocating joint production costs to categorys satisfies the requirements of § 1.471-7, or whether Taxpayers joint production costs must be further allocated among detailed categorys to satisfy the requirement of § 1.471-7 that the joint cost allocation “bear a reasonable relation to the selling values of the different kinds, sizes, or grades of product.”

Section 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) 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 Commissioner, does clearly reflect income.

Section 263A provides that in the case of tangible personal property that is inventory in the hands of the taxpayer, all of the direct and indirect costs of producing such property shall be included in inventory costs. The term "produce" includes construct, build, install, manufacture, develop, or improve. Section 263A(g)(1).

Section 471(a) provides that whenever, in the opinion of the Commissioner, the use of inventories is necessary in order to clearly determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Commissioner may prescribe as conforming as nearly as may be to the best practice in the trade or business and as most clearly reflecting income.

Section 1.471-7 provides that a taxpayer engaged in mining or manufacturing who by a single process or uniform series of processes derives a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike, and who in conformity to a recognized trade practice allocates an amount of cost to each kind, size or grade of product, which in the aggregate will absorb the total cost of production, may, with the consent of the Commissioner, use such allocated cost as a basis for pricing inventories, provided such allocation bears a reasonable relation to the respective selling values of the different kinds, sizes, or grades of product.

Miners and manufacturers customarily use a joint cost accounting method when no individual product can be produced by a production process without the appearance of other products. For example, the copper mining process yields copper, silver, lead, and other metals. The copper miner cannot extract the copper without also extracting the other metals. The products yielded from a joint production process are called joint products. “Joint production costs are the costs of a single process that yields multiple products simultaneously.” Horngren, et. al., Cost Accounting: A Managerial Emphasis p. 536 (10th Ed. Prentice Hall 2000). “The splitoff point is the juncture in a joint production process where one or more products become separately identifiable.” Id.

The joint cost accounting method described in § 1.471-7 is based on the notion that income will be clearly reflected where the costs attributable to a joint production process are allocated to the resulting products on the basis of their ability to generate sales proceeds. Because the more valuable products sell for more, they are assigned a larger portion of the joint production costs. This allocation process is intended to produce reasonably similar profit margins on all categories of joint products.[5] However, even when a joint cost accounting method produces identical profit margins for each category, the method will not necessarily produce the same amount of profit or profit margin on each unit of product in a joint product category because joint cost accounting methods have an averaging affect on the cost of the specific units within a single category. The total joint production costs assigned to a joint product category are allocated equally among the units of product in that category. Thus, different sales of a product in the joint product category may produce a different amount of profit because the sales price on individual sales may vary but the cost of each unit is identical.[6] So

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[5]See generally, Horngren, et. al., Cost Accounting: A Managerial Emphasis p. 540-45 (10th Ed. Prentice Hall 2000). The authors describe several methods of allocating joint production costs based upon the sales value of products produced in a joint production process. Only one of those methods, the “constant gross-margin percentage net realizable value method,” necessarily produces equal profit margins for each joint product category (but only if the producer has no beginning inventory), and the author describes that method as a combination joint-cost and profit-allocation method. The “sales value at splitoff method” will produce equal profit margins for each joint product category if the producer has no beginning inventory and the products are sold at the splitoff point.

[6]To illustrate, assume a Miner produces Mineral 1 and Mineral 2 as a result of its mining process. At the end of the period, Miner has produced 100 units of Mineral 1 and 50 units of Mineral 2 for a total cost of $150. Miner sold 30 units of Mineral 1 for

long as this disparity in profit on individual sales results from different terms of sale that are not influenced by differences in physical characteristics of the product being sold, it is an acceptable effect of a joint cost accounting method.

Products produced by a joint production process are not always sold at the splitoff point. Products yielded at the splitoff point may need further processing before reaching a saleable state. To the extent that such further processing does not yield joint products, production costs incurred after the splitoff point are generally assigned to particular products using a specific tracing, burden rate, or standard cost method.[7] To the extent that such further processing yields joint products, a joint cost accounting method is necessary to allocate the joint costs among those products.

Taxpayer and the I.E. agree that Taxpayer should use a joint cost accounting method to account for the products that Taxpayer produces. The disagreement centers on the "products" to which joint production costs should be allocated. The Service granted Taxpayer permission to allocate joint production costs based on categorys. But many of the categorys are subject to further production processes and yield sub-categorys, some of which, in turn, are subject to further production into detailed categorys. The I.E. objects to the joint cost allocation at the category production level because it results in an average unit price for all detailed categorys produced from a single category.

The problem can be illustrated with an example. Assume that a producer purchases a raw material for $100, that a joint production process applied to that raw

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$60 and 40 units of Mineral 2 for $20 to Customer 1 and 50 units of Mineral 1 for $90 to Customer 2. The sales value of Mineral 1 is $1.875/unit ([$60 + $90] / 80 units), and the sales value of Mineral 2 is $0.50/unit ($20 / 40 units). Miner must allocate the $150 of cost between Mineral 1 and Mineral 2 based on the relative sales value of the total production. Thus, Mineral 1 is allocated $ 132.35 ({[100 units * $1.875] / [(100 units * $1.875) + (50 units * $0.50)]} * $150) and Mineral 2 is allocated $17.65 ({[50 units * $0.50] / [(100 units * $1.875) + (50 units * $0.50)]} * $150). The unit cost of Mineral 1 is $1.3235/unit ($132.35 / 100 units) and the unit cost of Mineral 2 is $0.353/unit ($17.65 / 50 units). The overall profit margin on both Mineral 1 and Mineral 2 was 29.4% ([$44.12 profit / $150.00 sales] and [$5.88 profit / $20.00 sales]). However, the sales of Mineral 1 to Customer 1 produced a profit margin of 34.0% ($0.68 profit / $2.00 sales), and the sales of Mineral 1 to Customer 2 produced a profit margin of 26.7% ($0.48 profit / $1.80 sales)]). The sales of the remaining 20 units of Mineral 1 may produce a different profit margin, depending upon the price at which they are sold.

[7]See generally Horngren, et. al., Cost Accounting: A Managerial Emphasis p. 536, et. seq. (10th Ed. Prentice Hall 2000).

material yields 50 units of Category 1 and 1,000 units of Category 2, and that Category 2 consists of 950 units of Detailed Category A and 50 units of Detailed Category B. Assume further that the selling price of Category 1 merchandise is $1.00/unit, the selling price of Detailed Category A merchandise is $0.15/unit, and the selling price of Detailed Category B merchandise is $5.00/unit. Finally, for purposes of this example, assume that there are physical differences between the merchandise in Category 1 and Category 2 and between the merchandise in Detailed Category A and Detailed Category B, and that the only joint production cost to be allocated is the cost of the raw material.

If raw material costs are allocated at the Category production level, the taxpayer would allocate $11.30 to Category 1 ({($1.00/unit * 50 units) / [($1.00/unit * 50 units) + ($0.15/unit * 950 units) + ($5.00/unit * 50 units)]} * $100) and $88.70 to Category 2 ({[($0.15/unit * 950 units) + ($5.00/unit * 50 units)]/ [($0.15/unit * 950 units) + ($5.00/unit * 50 units)]} * $100). The profit margin on Category 1 merchandise is 77.4% ($38.70 / $50) and the overall profit margin on Category 2 merchandise is 77.4% ($303.80 / $392.50). However, each unit of Category 2 merchandise would be allocated a cost of $0.089 and sales of Detailed Category A merchandise would yield a profit of $0.061/unit ($0.15 sales value - $0.089 cost) and sales of Detailed Category B merchandise would yield a profit of $4.911/unit ($5.00 sales value - $0.089 cost). Thus, the profit margin on Detailed Category A merchandise is 41% ($0.061 profit / $0.15 sales value), and the profit margin on Detailed Category B merchandise is 98% ($4.9113 profit / $5.00 sales value).

If, on the other hand, the producer allocates joint production costs at the Detailed Category level, the taxpayer would allocate $11.30 to Category 1[8] ({[$1.00/unit * 50 units]/ [($1.00/unit * 50 units) + ($0.15/unit * 950 units) + ($5.00/unit * 50 units)]} * $100), $32.20 to Detailed Category A ({[$0.15/unit * 950 units]/ [($1.00/unit * 50 units) + ($0.15/unit * 950 units) + ($5.00/unit * 50 units)]} * $100), and $56.50 to Detailed Category B ({[$5.00/unit * 50 units]/ [($1.00/unit * 50 units) + ($0.15/unit * 950 units) + ($5.00/unit * 50 units)]} * $100). The profit margin on Category 1 merchandise is 77.4% ($38.70 profit / $50 sales value), the profit margin on Detailed Category A merchandise is 77.4% ($110.30 profit / $142.50 sales value), and the profit margin on Detailed Category B merchandise is 77.4% ($193.50 profit / $250.00 sales value).

Section 1.471-7 permits a taxpayer to use a joint cost accounting method that allocates joint production costs among the different kinds, sizes, or grades of product, the unit cost of which is substantially alike, resulting from a single production process or uniform series of production processes provided such allocation bears a reasonable

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[8] Category 1 is considered a Detailed Category under this allocation methodology.

relation to the respective selling values of the different kinds, sizes, or grades of product. The objective of this joint cost accounting method is to allocate production costs to the various kinds, sizes and grades of products produced based on the relative selling values of each kind, size, and grade. To the extent a joint product category contains products with different physical characteristics and selling values, the objective of this joint cost accounting will be frustrated. Thus, the I.E. believes that "the unit cost of which is substantially alike" implies that the products within a joint product category have substantially similar physical characteristics and selling values. The I.E. argues that when products are produced through a series of processes, all of which are joint production processes, a taxpayer must allocate joint production costs to the products produced at the final splitoff point rather than some intermediate splitoff point. Otherwise, the averaging affect of the joint cost accounting method will assign an incorrect unit cost to the various kinds, sizes, and grades of products that are sold to customers.

Taxpayer points out that in order to change a taxpayer's method of accounting under § 446(b), the Service must demonstrate that the taxpayer's method does not clearly reflect income. Dayton Hudson Corp. v. Commissioner, 153 F.3d 660 (8th Cir. 1998); Ansley-Sheppard-Burgess v. Commissioner, 104 T.C. 367 (1995). Taxpayer argues that the standard for evaluating whether an inventory accounting method clearly reflects income is whether the method determines the taxpayer's overall cost of goods sold and ending inventory for the taxable year with reasonable accuracy. Taxpayer further argues that any collateral effects of the method of accounting (specifically, the effect of the method on the cost of export sales and the amount allowable as a FSC commission) are not properly considered in the clear reflection of income evaluation. Because Taxpayer's ending inventory is *de minimis*, Taxpayer argues that any change to its joint cost accounting method will not materially change its total cost of goods sold or ending inventory for the taxable year. Therefore, Taxpayer argues that its method of accounting clearly reflects income.

Prior to Year 5, Taxpayer's method of accounting merely valued ending inventory and assigned the remainder of its production costs to cost of goods sold. Taxpayer filed a Form 3115 in Year 5 because its method of accounting for inventory failed to assign a unit cost to each item of inventory that it produced. Yet Taxpayer argues here that it is unnecessary for an inventory cost accounting method to accurately assign costs to each unit of inventory. Under Taxpayer's theory, it could choose any one of the separation points in a series of joint production processes as the joint cost allocation point and satisfy the clear reflection of income requirements of the Code and regulations as long as it had little or no ending inventory. At the conference of right, Taxpayer's representatives stated that the clear reflection of income standard would be satisfied even where a taxpayer assigned all of its production costs to one product and none of its production costs to other products if the taxpayer had little or no ending inventory. We disagree.

In order to clearly reflect income from the sale of products produced in a joint production process, a taxpayer must use a cost accounting method that accurately allocates joint production costs to the joint products. A cost accounting method is intended to accurately assign costs to property produced by the taxpayer. See generally, § 263A; § 1.471-3; § 1.471-7; § 1.471-11. Section 263A requires that all direct and indirect production costs be allocated to property produced by the taxpayer that is properly included in inventory. Section 1.263A-1(c)(1) specifies that section 263A costs allocated to production activities must be allocated to the items of property produced during the taxable year and capitalized to the items that remain on hand at the end of the taxable year. Section 1.471-7 permits a taxpayer to allocate joint production costs on the basis of the relative sales value of the joint products. Together, these provisions require taxpayers to accurately allocate production costs to the different products produced in a joint production process. A taxpayer may not allocate joint production costs at an intermediate splitoff point when the articles produced at that point are further separated in a joint production process and the resulting products have different physical characteristics and selling values. In the instant case, Taxpayer's method of allocating joint production costs does not clearly reflect income because it fails to accurately assign the production costs to the joint products produced by Taxpayer. Taxpayer must further allocate costs assigned to a category among the joint products,[9] if any, that are produced from that category using a joint cost accounting method in order to clearly reflect income.

Issue 3. Whether § 1.471-7 requires that Taxpayer divide its export products and similar domestic products into separate categories because the disparate selling prices commanded by export and domestic products result from differences in their size, kind, or grade.

Because the accounting method change proposed by the I.E. primarily affects the amount of the allowable FSC commission, the I.E.'s arguments focus on the differences of products sold in foreign markets. According to the I.E., a more accurate joint cost accounting method will result in more costs being allocated to the products sold in foreign markets because those products are generally the more valuable of the products produced by Taxpayer from a given category. Although the more valuable products are also sold domestically, the lower value products produced from a given category are sold almost exclusively in the domestic market. The I.E. focuses on the fact that foreign customers are often willing to pay more for a given detailed category

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[9]Here, the term joint product is used generically to describe products produced from a single process or uniform series of processes that have different physical characteristics and selling values. The joint products produced by Taxpayer from a particular category may be sub-categorys, detailed categorys, or groups of detailed categorys.

than domestic customers. The I.E. argues that the products are modified to suit the particular requirements of foreign customers and these modifications require that they be placed in a separate joint product category because they are different by kind, size, or grade.

Taxpayer does not dispute the fact that the sub-categorys or detailed categorys produced from a given category may vary substantially in physical characteristics as well as sales value. However, Taxpayer disputes the I.E.'s assertion that detailed categorys are modified for customers in foreign markets so that the product included in a particular detailed category can be further segregated between foreign and domestic sales. According to Taxpayer, the products within a particular detailed category sold in foreign markets are identical to those sold in domestic markets, but that the foreign customers are simply willing to pay more for those products. However, Taxpayer produces some detailed categorys that are sold exclusively to domestic customers and some that are sold exclusively to foreign customers.

Both Taxpayer and the I.E. agree that § 1.471-7 does not require Taxpayer to divide its domestic and export products into separate joint product categories solely by reason of disparate selling prices. Both Taxpayer and the I.E. agree that § 1.471-7 requires separate joint product categories by reason of physical differences (i.e., size, kind, or grade) in the products regardless of where sold. Taxpayer and the I.E. disagree, however, on the issue of whether the products sold by Taxpayer to domestic customers are physically identical to the products sold by Taxpayer to foreign customers.

Our resolution of Issue 2, above, and Issue 5, below, obviates the need to resolve this issue.

Issue 4. Whether § 1.925(a)-1T(c)(6)(iii) imposes an additional standard for the allocation of production costs. If so, whether Taxpayer's allocation method satisfies that standard.

Sections 921 through 927 implement the FSC regime, which provides tax incentives for domestic production of qualifying merchandise for export. Under these provisions, a portion of the "foreign trade income" earned by a FSC is not subject to taxation. § 925(a). Foreign trade income of a FSC consists of the gross income of the FSC that is attributable to foreign trading gross receipts. § 923(b); § 1.923-1T(a). "If the FSC is a commission agent on the sale of export property by its related supplier, the FSC's gross income is the commission paid or payable by the related supplier to the FSC with respect to transactions that would have generated foreign trading gross receipts had the FSC been the principal on the transaction." Id.; see also § 1.925(a)-1T(f), Example (6) (FSC and its related supplier may elect to include all expenses related to the export transactions on the books of the FSC and to increase the amount of the commission payable to the FSC by that amount). The "exempt foreign trade income" that results from these calculations is treated as foreign-source income that is not effectively connected with the conduct of a trade or business in the United States, and therefore not subject to U.S. taxation. §§ 921(a), 923. Nor is this category of income subject to U.S. tax when repatriated as dividends from the FSC. § 245(c).

Section 925(a) and the regulations thereunder specify three alternative methods of determining the taxable income of a FSC: (a) 1.83% of foreign trading gross receipts of the FSC (limited to 46% of CTI of the FSC and the related supplier); (b) 23% of CTI of the FSC and the related supplier; or (c) the sales price actually charged to the FSC (subject to § 482 rules). See § 1.925(a)-1T(c). Methods (a) and (b), which are referred to as the "administrative pricing" methods, allocate to the FSC a portion of the total proceeds from export sales. The FSC and related supplier may elect the administrative pricing methods in lieu of using the sales price actually charged (subject to § 482 rules) only if the FSC (or another party under contract with the FSC) performs certain economic processes. See § 925(c). The administrative pricing rules apply both where the FSC takes title to the goods and re-sells them and, as in this case, where the FSC acts as an agent and receives a commission on the export transaction involving a related supplier.

The administrative pricing rules were intended to eliminate the need for difficult, case-by-case determinations of arm's length transfer prices for transactions between a related supplier and the FSC:

> Congress intended that the pricing principles that govern the determination of the taxable income of a FSC comply with the GATT rules. If export property is sold to a FSC by a related person (or a commission is paid by a related principal to a FSC with respect to export property), the taxable income of the FSC and related person is based upon a transfer price determined under an arm's length pricing approach or under one of two formulae which are intended to approximate arm's length pricing.

Staff of Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 1054 (1984) (emphasis added). See also H.R. Rep. No. 533, 92d Cong., 1st Sess. 1, 58 (1971), 1972-1 C.B. 498, 529 (DISC); S. Rep. No. 437, 92d Cong., 1st Sess. 1, 90 (1971), 1972-1 C.B. 559, 609 (DISC).

Under the CTI method, one starts with the combined income of the related supplier and the FSC from export transactions. In the case of a commission FSC (such as Taxpayer - FSC), the CTI of the FSC and the related supplier consists of the gross receipts which would have been foreign trading gross receipts had the sale been made directly by the FSC, minus the related supplier's and the FSC's total costs. § 1.925(a)-

1T(d)(2)(iii).[10] For these purposes, costs exclude the commission paid or payable to the FSC, but include "the related supplier's cost of goods sold and its and the FSC's noninventoriable costs . . . which relate to the gross receipts from the transaction." Id. (emphasis added). See also § 1.925(a)-1T(c)(6)(i).[11] The resulting CTI is then split, 23% to the FSC and 77% to the related supplier. § 925(a)(2); see also § 1.925(a)-1T(f), Example 6. Thus, a FSC commission determined under the CTI method is a direct function of the cost of goods sold attributable to export sales, as determined by the related supplier. If the related supplier's method of accounting inaccurately states the cost of goods sold related to exports, the foreign trade income of the FSC, as well as the amount of income ultimately not subject to tax, will also be misstated.[12]

The following substantive requirements apply to the method(s) of accounting used by the U.S. related supplier and/or the FSC:

> (iii) Rules for determination of gross receipts and total costs. In determining the gross receipts of the FSC and the total costs of the FSC and related supplier which relate to such gross receipts, the rules set forth in subdivision (iii)(A) through (E) of this paragraph shall apply.
>
> > (A) Subject to the provisions of subdivision (iii)(B) through (E) of this paragraph, the methods of accounting used by the FSC and related supplier to compute their taxable incomes will be accepted for purposes of determining the amounts of items of income and

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[10] Section 1.925(a)-1T(d)(2)(iii) provides: "The combined taxable income of a FSC and the related supplier from the transaction is the excess of the related supplier's gross receipts from the transaction which would have been foreign trading gross receipts had the sale been made by the FSC directly over the related supplier's and the FSC's total costs, excluding the commission paid or payable to the FSC, but including the related supplier's cost of goods sold and its and the FSC's non-inventoriable costs (citation omitted) which relate to the gross receipts from the transaction."

[11] "[T]he full costing combined taxable income of the FSC and its related supplier . . . is the excess of the foreign trading gross receipts of the FSC . . . over the total costs of the FSC and the related supplier including the related supplier's cost of goods sold and the FSC's noninventoriable costs . . . ." § 1.925(a)-1T(c)(6)(i) (emphasis added).

[12] Pursuant to § 923(b), foreign trade income consists of the gross income of the FSC attributable to foreign trading gross receipts (in this case FSC commissions plus total expenses incurred by the FSC).

> expense (including depreciation) and the taxable year for which those items are taken into account.
>
> (B) A FSC may, generally, choose any method of accounting permissible under section 446(c) and the regulations under that section. However, if a FSC is a member of a controlled group (as defined in section 927(d)(4) and §1.924(a)-1T(h)), the FSC may not choose a method of accounting which, when applied to transactions between the FSC and other members of the controlled group, will result in a material distortion of the income of the FSC or of any other member of the controlled group. Changes in the method of accounting of a FSC are subject to the requirements of section 446(e) and the regulations under that section.
>
> (C) Cost of goods sold shall be determined in accordance with the provisions of §1.61-3. See sections 471 and 472 and the regulations thereunder with respect to inventories. With respect to property to which an election under section 631 applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold shall be determined by applying §1.631-1(d)(3) and (e) (relating to fair market value as of the beginning of the taxable year of the standing timber cut during the year considered as its cost).
>
> (D) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are the expenses, losses, and deductions definitely related, and therefore allocated and apportioned thereto, and a ratable part of any other expenses, losses, or deductions which are not definitely related to any class of gross income, determined in a manner consistent with the rules set forth in §1.861-8. The deduction for depletion allowed by section 611 relates to gross receipts from sales of export property and shall be taken into account in computing the combined taxable income of the FSC and its related supplier.

§ 1.925(a)-1T(c)(6)(iii) (emphasis added). See also § 1.925(a)-1T(d)(2)(iv) (incorporating FSC's total costs as determined under paragraph -1T(c)(6)).

The FSC provisions replicated the alternative "buy-sell" and "commission" structures that existed under the predecessor domestic international sales corporation (DISC) rules. Compare § 925(b) and § 1.925(a)-1T(d)(2) (FSC) with § 994(b) and § 1.994-1(d) (DISC). The reference in § 1.925(a)-1T(c)(6)(iii)(B) to the FSC's "choice" of a method of accounting (a provision in turn modeled on § 1.994-1(c)(6)), refers primarily to a buy-sell FSC.

The corresponding rules applicable to commission FSCs are contained in § 1.925(a)-1T(d)(2), which provides:

> (ii) the amount of income that may be earned by the FSC in any year is the amount, <u>computed in a manner consistent with paragraph (c) of this section</u>, which the FSC would have been permitted to earn under the gross receipts method, the combined taxable income method, or the section 482 method . . . .

§ 1.925(a)-1T(d)(2)(ii) (emphasis added). This regulation incorporates by reference, and makes applicable to commission FSCs, the substantive rules in § 1.925(a)-1T(c). Thus, the requirement in § 1.925(a)-1T(c)(6)(iii)(B) that the method of accounting "chosen" by the FSC is subject to the clear reflection of income standard of § 446,[13] and the prohibition against "material distortion" of the income of the FSC and the related supplier, is equally applicable to commission and to buy-sell FSCs.

As a threshold matter, the method of accounting used by a FSC and its related supplier to determine CTI must be valid under general income tax principles. <u>See</u> § 1.925(a)-1T(c)(6)(iii). A FSC and its related supplier may "generally" use any method of accounting that accords with section 446(c) and the regulations under that section. §§ 1.925(a)-1T(c)(6)(iii)(B), 1.925(a)-1T(d)(2). In addition, the cost of goods used to

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[13] Section 446 provides the general rules for methods of accounting. Section 446(c) states:

> Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting–
>
> (1) the cash receipts and disbursements methods;
> (2) an accrual method;
> (3) any other method permitted by this chapter; or
> (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

Section 446(b) provides the following exception to the above general rule:

> If no method of accounting has been regularly used by the taxpayer, or <u>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.</u> (Emphasis added.)

calculate CTI must accord with § 1.61-3. See §§ 1.925(a)-1T(c)(6)(iii)(C), 1.925(a)-1T(d)(2). This is not to say, however, that a method of accounting that otherwise constitutes a valid method of accounting for general income tax purposes may not, in some cases, be subject to adjustment by the Service pursuant to § 1.925(a)-1T(C)(6)(iii)(A)-(E).

Both buy-sell and commission FSCs, which often lack methods of accounting with respect to expense or income items used to compute CTI, are in effect bound by the method of accounting utilized by the related supplier to compute the transfer price or commission payable.[14] In the present case, the method of accounting used by Taxpayer to determine cost of goods sold constitutes a "method of accounting of the FSC" within the meaning of § 1.925(a)-1T(c)(6)(iii)(B), and is therefore subject to the "clear reflection of income" standard in § 446(b) as well as the prohibition against "material distortion" of the income of the FSC and the related supplier. Id. Thus, the related supplier's method of accounting must clearly reflect the income of both the related supplier and the FSC from export transactions. In other words, the related supplier's method of accounting must accurately measure the profit on export transactions by matching the revenue from such transactions against the related costs.

Under some circumstances, a method of accounting that accurately reflects the income of a taxpayer may nonetheless be inappropriate for calculation of CTI. In General Dynamics Corp. v. Commissioner, 108 T.C. 107 (1997), for example, the taxpayer used the completed-contract method of accounting for long-term contracts, and made a valid election to expense period costs in the years in which the costs were incurred. Merchandise subject to these contracts was sold in subsequent years through a DISC (direct predecessor of FSC). The Tax Court held that, for purposes of determining CTI, previously-deducted period costs should be attributed to gross receipts from exports in the current tax year. Summarizing the Commissioner's argument under the applicable DISC regulation (§ 1.994-1(c)), the court stated:

> [R]espondent argues that, in accord with the congressional intent as reflected in the administrative history, the regulations require a taxpayer to account for all costs that relate to export sales, including period costs deducted in prior years. Respondent further argues that petitioners' accounting method and any permissible variations

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[14] Application of the same rules to commission and buy-sell FSCs in this context is consistent with the rules for calculation of "gross receipts." See § 1.927(b)-1T(d), (e)(1)(i). See also § 1.993-6(d), (e); Hughes International Sales Corp. v. Commissioner, 100 T.C. 293, 299 (1993) (in applying the "95% gross receipts test," DISC may use the same method as its related supplier for both "gross receipts" and "qualified export receipts").

> therefrom do not control in determining the statutory limitations for computing CTI. We agree with respondent.

108 T.C. at 119.

The Tax Court determined that the method of accounting used by the taxpayer in General Dynamics inappropriately excluded certain expenses from the CTI computation:

> In this case . . . petitioners try to use the completed contract method to avoid the matching of costs with income from export sales for purposes of computing CTI as required by the regulations under section 994 and 925. As a result, petitioners did not subtract all the costs related to their export sales as defined in section 1.994-1(c)(6)(iii), Income Tax Regs., from the export income that the expenditures generated.

General Dynamics, 108 T.C. at 127. The court held that the exclusion of costs from the export-sales cost base distorted the income of the DISC. 108 T.C. at 128. See also Longview Fibre Co. v. Commissioner, 71 T.C. 357 (1978) (under DISC regime, fair market value of logs under § 631(a) rather than taxpayer's basis therein, must be used to determine cost of exported wood articles).

We determined above that Taxpayer's joint cost accounting method does not clearly reflect income under general income tax principles because it fails to accurately assign the production costs to the joint products produced by Taxpayer. In addition, Taxpayer's joint cost accounting method fails to clearly reflect the export income of Taxpayer and Taxpayer - FSC, and is therefore impermissible under § 1.925(a)-1T(c)(6)(iii). The production costs allocated to the various joint products must reflect variations in the grade, volume, and value of merchandise sold in domestic and export markets. However, due to the predominance of lower-priced domestic sales of products that fall within certain categorys, Taxpayer allocates d- and f-acquisition and production costs based on a relative sales value that is heavily weighted toward domestic as opposed to export sales. Consequently, Taxpayer's joint cost accounting method shifts the costs of goods sold away from export sales to domestic sales, thereby excluding costs attributable to export sales from CTI. Therefore, Taxpayer's joint cost accounting method distorts the income from export sales and the income of the FSC.

Issue 5. Whether the accounting method change consent letter may be retroactively modified or revoked if it is determined that Taxpayer's method of allocating joint production costs does not satisfy the requirements of § 1.471-7 or § 1.925(a)-1T(c)(6)(iii).

Section 12.04 of Rev. Proc. 99-1, 1999-1 I.R.B. 6, provides that a letter ruling found to be in error or not in accord with the current views of the Service may be revoked or modified. If a letter ruling is revoked or modified, the revocation or modification applies to all years open under the statute of limitations unless the Service uses its discretionary authority under § 7805(b) to limit the retroactive effect of the revocation or modification.

We have determined that the consent letter should be revoked because it erroneously granted Taxpayer permission to use a method of accounting that does not clearly reflect income. Therefore, we must determine whether the revocation will have retroactive effect or whether the retroactive effect will be limited under § 7805(b).

Section 7805(b)(8) provides that the Commissioner may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws shall be applied without retroactive effect. Section 601.204(c) of the Regulations on Procedure and Administration provides that written permission to a taxpayer by the national office consenting to a change in his accounting method is a "ruling." See also section 2.01 of Rev. Proc. 99-1.

Section 601.201(l)(5) provides, in part, that except in rare or unusual circumstances, the revocation or modification of a ruling will not be applied retroactively with respect to the taxpayer to whom the ruling originally was issued or to a taxpayer whose tax liability directly was involved in such ruling if (i) there has been no misstatement or omission of material facts, (ii) the facts subsequently developed are not materially different from the facts on which the ruling was based, (iii) there has been no change in the applicable law, (iv) the ruling originally was issued with respect to a prospective or proposed transaction, and (v) the taxpayer directly involved in the ruling acted in good faith in reliance upon the ruling and the retroactive revocation would be to his detriment. See also section 12.05 of Rev. Proc. 99-1. The only criterion at issue in this case is whether the taxpayer misstated or omitted a material fact in the accounting method change request.

The I.E. argues that Taxpayer misled the national office by not making clear that categorys are further produced into y different a products and z different b products. According to the I.E., Taxpayer's submissions implied that it only sold # different a products and ## different b products. Taxpayer's submissions never explained the extent of the differences in the products that can be produced from a single category. The products produced from a single category can vary greatly in physical characteristics and value. If Taxpayer had disclosed all of the relevant facts, the national office would have known that Taxpayer's proposed method did not assign production costs to the goods produced with reasonable accuracy and would not have granted a change to the proposed method. The I.E. further believes that Taxpayer had a duty to disclose to the national office the impact that its proposed method of accounting would have on the amount of profit attributable to export sales and thus the allowable FSC commission.

Taxpayer argues that there was no omission, material or otherwise. On page 3 of Taxpayer's accounting method change request narrative, Taxpayer stated, "in its production process, Taxpayer produces the [d or f] into smaller and smaller segments in a continuous production process." Taxpayer argues that this statement makes clear that categorys are not final finished products. Taxpayer further argues that the I.E. participated in the accounting method change process and was aware of the fact that categorys were not final finished products. We agree with Taxpayer.

Taxpayer did not omit or misstate any material facts in its accounting method change request or in its response to the national office's request for additional information. This Technical Advice Memorandum (TAM) revokes the consent letter. However, under § 7805(b) the revocation will have prospective application only and Taxpayer may rely on the consent letter in accounting for joint production costs for taxable years beginning before the issuance date of this TAM. Taxpayer may not rely on the consent letter in accounting for joint production costs for taxable years beginning after the issuance date of this TAM. As such, for taxable years beginning before the date that this TAM is issued, an examining agent may not change Taxpayer's joint cost accounting method to another method of accounting for purposes of computing cost of goods sold, ending inventory, and the cost of export sales. An examining agent may nonetheless make adjustments to Taxpayer's federal income tax returns for those years that are necessary to ensure adherence to, and compliance with, the method of accounting granted in the consent letter.

In a Date 2 submission, Taxpayer represented that it intends to file an accounting method change request relating to the method of determining the cost of joint products for the first possible taxable year in order to change to an accounting method that would be acceptable to the Service. Taxpayer may request to change to a joint cost accounting method that clearly reflects income pursuant to Rev. Proc. 97-27, 1997-1 C.B. 680, at any time before Taxpayer's federal income tax return for the first taxable year beginning after the date that this TAM is issued is under examination (as defined in section 3.07 of Rev. Proc. 97-27). However, if Taxpayer files a request to change its joint cost accounting method for any taxable year after the first taxable year beginning after the issuance date of this TAM, the Service may, in the interest of sound tax administration, exercise its discretion under section 8.02 of Rev. Proc. 97-27 (or any successor) and provide terms and conditions that differ from the normal terms and conditions, e.g., a different year of change. Even if Taxpayer's returns for prior taxable years are under examination, Taxpayer may request to change its method of accounting pursuant to section 6 of Rev. Proc. 97-27, i.e., during a window period or with the District Director's consent. Although a taxpayer under examination generally may not request consent to change an accounting method that is an issue under consideration, the relief granted under § 7805(b) precludes an examining agent from making the propriety of Taxpayer's joint cost accounting method an issue under consideration.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.