Effective date: September 9, 1995

COORDINATED ISSUE
ALL INDUSTRIES
DOLLAR-VALUE LIFO
BARGAIN PURCHASE INVENTORY

ISSUES

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

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

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

FACTS

A bargain purchase occurs when a taxpayer acquires a bulk quantity of inventory at a price significantly lower than the normal cost of production or purchase. If a taxpayer who has made a bargain purchase is on, or later elects, the LIFO method of valuing inventories, the taxpayer may attempt to retain the cost of those bargain purchase items in the end of year inventory whether or not such items are physically present.

Typically, a new corporation will be organized to acquire most or all of the assets of an existing business. If possible, the new corporation will adopt a tax year that ends shortly after the date of the acquisition to ensure that all or most of the inventory purchased at bargain prices will be physically present and included in the LIFO valuation of ending inventory for the first (base) year. (Another method sometimes used by newly formed corporations involves an attempt to characterize the initial bargain cost inventory as opening inventory for the first taxable period. This is not permissible. See Rev. Rul. 85-172, 1985-2 C.B. 151.) The new corporation adopts the dollar-value LIFO method by filing a Form 970 with its return for its first taxable year. By making a LIFO election in the first taxable year and electing to use the earliest acquisition cost method to value increments, the taxpayer attempts to value its

entire base-year inventory at bargain cost. The use of bargain cost as base-year cost ensures lower ending inventory values for subsequent years under the required LIFO index calculations. These lower ending inventory values translate to higher deductions for cost of goods sold.

LAW

I.R.C. Sec. 472(a) permits a taxpayer to elect the LIFO inventory method. The use of LIFO, however, must be in accordance with the regulations, must be applied on a consistent basis, and must clearly reflect income. In addition, inventories valued under LIFO must not be valued lower than cost.

Treas. Reg. Sec. 1.472-8 prescribes the operating rules for the use of the dollar-value method of pricing LIFO inventories. Treas. Reg. Sec. 1.472-8(e)(1) is the basic provision outlining the use of the double-extension, the index, and the link-chain methods of pricing LIFO inventories. Among other things, this section states that the appropriateness of the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns.

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

The treatment of inventories for tax purposes is governed by I.R.C. Sec. 446 and Sec. 471. These sections grant the Commissioner broad discretion in matters of inventory accounting and give her wide latitude to adjust a taxpayer's method of accounting for inventory so as to clearly reflect income. Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979). The Commissioner's determination with respect to the clear reflection of income is given more than the usual presumption of correctness, and the taxpayer bears a heavy burden of overcoming a determination that a method of accounting does not clearly reflect income.

Once the Commissioner determines that a taxpayer's method of accounting does not clearly reflect income, she may select for the taxpayer a method which, in her opinion, clearly reflects income. The taxpayer has the burden of showing that the method selected by the Commissioner is incorrect, and such burden is extremely difficult to carry. Photo-Sonics, Inc. v. Commissioner, 357 F.2d 656 (9th Cir. 1966). The

Commissioner's determination as to the proper method of accounting for inventory must be upheld unless shown to be plainly arbitrary. Lucas v. Kansas City Structural Steel Company, 281 U.S. 264 (1930).

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

I.R.C. Sec. 481(a) provides that, if a taxpayer's method of accounting is changed, the taxpayer is required to make an adjustment (known as a section 481 adjustment) in order to prevent amounts from being duplicated or omitted by reason of change.

The Tax Court stated in Hamilton Industries, Inc. v. Commissioner, 97 T.C. 120 (1991) that a change in the method of valuing closing inventory constitutes a change in the method of accounting to which section 481 applies. In addition, the court held that if adjustments affect the timing of the inclusion of income deferred by the taxpayer, those adjustments constitute a change in the method of accounting.

DISCUSSION

Issue 1: This issue involves the bargain purchase of inventory and the subsequent use of those bargain costs as base year costs in the computation of the value of the LIFO inventory. The issue usually arises because the acquiring corporation fails to account for the items purchased at the bargain price separately from other items subsequently purchased or manufactured. Hamilton discusses a taxpayer which had made two bargain purchases in prior tax years.

Separate item accounting can be distinguished from separate pool accounting (although, in this context, there is no practical difference). The Tax Court in UFE, Inc. v. Commissioner, 92 T.C. 1314 (1989) declined to accept the Commissioner's argument that a separate resale pool was required to account for bargain purchased finished goods inventory held for resale, even though Treas. Reg. Sec. 1.472-8(b)(2)(i) provides that separate pools are required for manufacturing and resale operations. Service personnel need not argue for the establishment of separate pools in this context since separate item accounting is sufficient to segregate (and perhaps eliminate) the bargain cost inventory.

The bargain discounts in Hamilton were 94 percent and 60 percent. The court looked closely to the opinion in Amity Leather Products v. Commissioner, 82 T.C. 734 (1984), because it was the only precedential case, at the time, which dealt with the meaning of the term "item" as used in the dollar-value regulations in the context of a manufacturing business. In Amity, the court decided that "because the change in the price of an item determines the price index and the index affects the computation of increments and decrements in the LIFO inventory, the definition and scope of an item are extremely important to the clear reflection of income."

The Amity court further stated that if factors other than inflation enter into the cost of inventory items, a reliable index cannot be computed. If the discounted cost is different from the cost of inventory acquired later, the discount represents a factor other than inflation.

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

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

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

The Hamilton court concluded that the bargain purchase inventory had to be treated as items separate from the inventory acquired or produced subsequent to such acquisitions. Such treatment avoids a distortion of the taxpayer's income, and results

in a clearer reflection of income. The court ruled that the discounted items were different from other items purchased subsequently, even though physically identical, because the costs were very different. Therefore, to clearly reflect income, separate tracking of the bargain cost items was required.

Issue 2: Treas. Reg. Sec. 1.446-1(a)(1) provides that the term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. See also Treas. Reg. Sec. 1.446-1(e)(2)(ii)(a). In Hamilton, the Tax Court stated that a change in the method of valuing closing inventory constitutes a change in method of accounting to which section 481 applies. 97 T.C. at 126. The Hamilton court held that the Commissioner's adjustments, which reflected the necessity of separate item accounting for bargain purchase inventory, constituted a change in method of accounting. Id. at 127.

Announcement 91-173, 1991-47 I.R.B. 29, provides that the Service will require taxpayers to compute and take a net section 481(a) adjustment into account for a change in method of accounting relating to certain bulk purchases of inventory under the holding in Hamilton.

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

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

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

did not accept Hamilton's argument. See, e.g., Hitachi Sales Corporation of America v. Commissioner, T.C. Memo. 1994-159 (once the Commissioner determines that a change in accounting method is required, the petitioner bears the burden, under Tax Court Rule 142(a), of proving that related section 481 adjustments made by the Commissioner are incorrect).

CONCLUSIONS

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

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

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