

Technical Advice Memorandum 9853003, 1/04/1999, IRC Sec(s). Unspecified

Headnote:

The Service has ruled in technical advice that a car dealer incorrectly reconstructed the beginning of the year cost of used vehicles in computing an inflation index for its used vehicle LIFO pools and that its dual index method of valuing increments in its LIFO pools does not clearly reflect income.

The dealer used an official used car guide (Black Book) to reconstruct the beginning of the year cost of used vehicles in ending inventory. To determine the beginning of the year value for a used vehicle, the dealer used the Black Book covering the last week of the previous December for a similar vehicle. The dealer now believes that it should have reconstructed the beginning of the year cost of used vehicles using the Black Book covering the last week of its prior tax year.

The Service concluded that if the car dealer reconstructs beginning of the year cost using the Black Book covering the last day of its prior tax year, the dealer would compute an annual inflation index in excess of actual inflation for a 12-month period. The Service ruled that the dealer must reconstruct the beginning of the year cost for a new item in its used vehicle inventory pool by reference to the value of the previous year's model listed in an official used car guide for the day 52 weeks before the date the dealer acquired the vehicle.

The dealer also used a dual index method to price increments in its new and used vehicle LIFO pools. The dealer compared its latest acquisition costs of vehicles on hand in ending inventory with the beginning of the year cost of those vehicles to develop an annual inflation index. The dealer linked this index to the preceding year's cumulative index and divided it into the latest acquisition cost of the ending inventory to determine the base-year cost of the ending inventory. If there was an increment in terms of base-year cost for the year, the dealer multiplied the cumulative index from the preceding year by the base-year cost of the increment to determine the LIFO value of the increment.

The Service noted that acceptable methods of valuing LIFO increments are based on the current year cost of items, not the prior year cost of those items. The Service ruled that the dealer's dual index method does not clearly reflect income because it values dollar-value LIFO increments based on prior year costs rather than current year costs.

ISSUES

1. Whether Taxpayer has correctly reconstructed the beginning of the year cost of used vehicles for purposes of computing an inflation index for its used vehicle LIFO pools.
2. Whether Taxpayer's dual index method of valuing increments in its new and used vehicle LIFO pools clearly reflects income.

CONCLUSIONS

1. For purposes of computing an annual inflation index, the beginning of the year cost for a new item in a used vehicle inventory pool must be reconstructed by reference to the value of the previous year's model of that particular vehicle listed in an official used car guide covering the day 52 weeks prior to the date that the vehicle was acquired by Taxpayer.

2. Taxpayer's dual index method of valuing dollar-value LIFO increments in its new and used vehicle pools does not clearly reflect income because it values the increments based on prior-year costs rather than current-year costs.

FACTS

Taxpayer is a franchised automobile dealer and is engaged in the purchase, sale, and service of new X automobiles and light-duty trucks. Taxpayer is also engaged in the acquisition and sale of all makes and models of used vehicles. Taxpayer acquires used vehicles from customers through trade-ins and at wholesale auctions. At the conference of right, Taxpayer represented that its policy is to sell at auction any used vehicle after it has been on hand for 60 days, but acknowledged that some vehicles may remain on hand for up to 90 days before they are sold at auction. Thus, according to Taxpayer, most used vehicles on hand at the end of the taxable year were acquired within the past 60 days.

Taxpayer began accounting for its new vehicle inventories using the dollar-value last-in, first-out (LIFO) method with the taxable year ended Date 1. Taxpayer filed a Form 970 electing to use the LIFO inventory method for used vehicles beginning with the taxable year ended Date 2. Taxpayer's Form 970 included an election to use a link-chain, dollar-value LIFO method in conjunction with the earliest acquisitions method of valuing increments.

Although Taxpayer elected to value LIFO increments in its new and used vehicle pools using the earliest acquisitions method, Taxpayer, in fact, valued LIFO increments using a dual index method. Rather than ascertaining an earliest acquisition cost for the items in ending inventory, Taxpayer determined the current-year cost of each used vehicle acquired by purchase by reference to the actual purchase price and each used vehicle acquired in trade by reference to the Black Book covering the day on which the vehicle was acquired. Taxpayer computed an annual inflation index by double extending the items in its ending inventory at beginning of the year cost and current-year cost. The total current-year cost was then divided by the total beginning of the year cost to ascertain the annual index. The annual index, thus computed, was then multiplied by the previous year's cumulative index to derive the current-year cumulative index. The current-year cost of the ending inventory in the pool was then divided by the current-year cumulative index to determine the total base-year cost of the ending inventory. If the base-year cost of the ending inventory exceeded the base-year cost of the beginning inventory, Taxpayer determined the LIFO value of the increment by multiplying the increment by the previous year's cumulative index.

Taxpayer treated each used vehicle on hand at the end of the year as a new item. In other words, Taxpayer assumed that, for each used vehicle in ending inventory, it had no similar item at the beginning of the year. Taxpayer reconstructed the beginning of the year cost of each used vehicle by reference to an official used car guide, the Black Book, effective for December 31 of the preceding calendar year, even though December 31 was not the end of its taxable year. Using that edition of the Black Book, Taxpayer would ascertain the value of the previous year's model of that particular vehicle. To illustrate, assume that at the end of the 1996 taxable year, Taxpayer's used vehicle pool included a 1995 Chevrolet Corvette. Taxpayer would determine the beginning of the year cost of that vehicle by reference to the value of a similar 1994 Chevrolet Corvette listed in the Black Book effective for December 31, 1995.

Taxpayer filed a Form 3115 requesting to change its LIFO pooling method beginning with the taxable year Date 3. 1 Taxpayer requested to change from its method of using two dollar-value LIFO pools (one

for new vehicles and one for used vehicles) to a method of using four dollar-value LIFO pools (one for new automobiles, one for new trucks, one for used automobiles, and one for used trucks). The Commissioner consented to Taxpayer's requested change subject to certain enumerated conditions. The conditions relevant to this request for technical advice are:

(5) that the taxpayer "double extends" all items in its ending inventory pool(s) of new and used vehicles at the taxpayer's own current year-end cost and its own prior year-end cost; the resulting current-year index is linked back to the base year by multiplying it by the cumulative price index. THE ITEMS USED TO COMPUTE THE TAXPAYER'S OWN PRIOR-YEAR COST AND ITS OWN CURRENT-YEAR COST SHALL BE COMPARABLE (E.G., VEHICLES SHALL BE COMPARABLE IN TERMS OF BASE VEHICLE MODEL, OPTIONS AND ACCESSORIES) IN ORDER FOR THESE INDEXES TO CLEARLY REFLECT INCOME (emphasis in original);

(7) that the taxpayer computes its current-year index for new vehicles by extending each item (i.e., each vehicle, including its accessories and options) in the inventory pool(s) at the close of the year at both the beginning of the year cost and the current-year cost. The current-year costs of each item will be its actual invoice cost (taking into account freight-in and any other appropriate adjustments to obtain the taxpayer's cost). The beginning of the year cost must be the cost of the equivalent item in the prior year's ending inventory. If the item was in existence at the beginning of the year but not stocked by the taxpayer, the taxpayer must establish, by using available data or records, what the cost of the item would have been to the taxpayer had the taxpayer stocked the item at the beginning of the year of change. The principles of section 1.472-8(e)(2)(iii) must be used for new vehicles in ending inventory that were not in existence at the beginning of the year; and

(8) that the taxpayer computes its current-year index for used vehicles by extending each item (i.e., each vehicle) in the inventory pool at the close of the year at both the beginning of the year cost and the current-year cost. The current-year costs of each item will be its acquisition cost as determined on the date of acquisition by reference to the actual transaction if a cash purchase, or by reference to the value indicated in an official used car guide on the date of acquisition if a trade-in. The beginning of the year cost must be the cost of the equivalent item in the prior year's ending inventory. The beginning of the year cost of the equivalent item is the cost of that particular vehicle's previous year's model. If the item was in existence at the beginning of the year but not stocked by the taxpayer, the taxpayer must establish, by using available data or records, what the cost of the item would have been to the taxpayer had the taxpayer stocked the item at the beginning of the year of change. If the available data includes an external publication, such publication, if consistently available, must be consistently used. The principles of section 1.472-8(e)(2)(iii) must be used for used vehicles in ending inventory that were not in existence at the beginning of the year. (That is, the used vehicle would be treated as if it were a new vehicle for purposes of determining if it was in existence at the beginning of the year.)

The consent letter further provided:

The permission granted in this ruling letter, as well as the audit protection provided in section 10.12 of Rev. Proc. 92-20, are limited to the specific change(s) in method of accounting regarding the particular LIFO sub-methods, as listed in the first paragraph of this letter. 2

Notwithstanding the permission granted in this letter, as provided in section 1.472-8(d) of the regulations, whether the number and the composition of the pool or pools used by the taxpayer are appropriate, as well as the propriety of all computations incidental to the use of such pool or pools,

including (but not limited to) those computations relative to the definition of a LIFO item of inventory, the definition and treatment of new items, and the use, accuracy, and reliability of the link-chain method, including the determination of current-year cost of items under section 1.472-8(e)(2)(ii) of the regulations, remain subject to determination by the District Director in connection with the examination of the taxpayer's income tax returns.

Although some information may have been presented regarding the computations relative to the use of the link-chain method, including those relative to the definition of a LIFO item of inventory, the treatment of new items, and the use, accuracy, and reliability of the link-chain method, no final determination can be made by this office regarding the use, accuracy, and reliability of such method. In this connection, see section 1.472-8(e) of the regulations.

Taxpayer computed taxable income for the taxable year ended Date 3 using four LIFO pools to account for its new and used vehicle inventory. Taxpayer continued using a dual index method of pricing LIFO increments for all of its LIFO pools. In addition, Taxpayer continued treating each used vehicle in ending inventory as a new item.

The Service is currently examining Taxpayer's federal income tax return for the taxable year ended Date 3. The examining agent believes that Taxpayer has incorrectly determined the beginning of the year cost of new items in its used vehicle pools. The examining agent further believes that Taxpayer's dual index method of valuing LIFO increments fails to clearly reflect income.

LAW

Section 471(a) of the Code 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 472(a) provides that a taxpayer may use the LIFO method in inventorying goods specified in an application to use such method. The change to, and the use of, such method should be in accordance with such regulations as the Secretary may prescribe as necessary in order that the use of such method may clearly reflect income.

Section 472(b) provides that under the LIFO method goods comprising ending inventory are treated as first being those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof; and second, those acquired in the taxable year.

Section 472(b) further provides that in inventorying goods under the LIFO method, the taxpayer shall inventory them at cost. Section 1.472-3(d) of the Income Tax Regulations provides that whether or not the taxpayer's application for adoption and use of the LIFO inventory method should be approved, and whether or not such method, 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.

Section 1.472-8(a) provides that any taxpayer may elect to determine the cost of its LIFO inventories under the so-called "dollar-value" LIFO method, provided such method is used consistently and clearly reflects income. The dollar-value method of valuing LIFO inventories is a method of determining cost by

using "base-year" cost expressed in terms of total dollars rather than the quantity and price of specific goods as the unit of measurement.

Section 1.472-8(e)(1) provides that a taxpayer may ordinarily use only the so-called "double-extension" method for computing the base-year and current-year cost of a dollar-value inventory pool. Where the use of the double-extension method is impractical, because of technological changes, the extensive variety of items, or extreme fluctuations in the variety of the items, in a dollar-value pool, the taxpayer may use an index method for computing all or part of the LIFO value of the pool. An index may be computed by double-extending a representative portion of the inventory in a pool or by the use of other sound and consistent statistical methods. The index used must be appropriate to the inventory pool to which it is to be applied. The appropriateness of the method of computing 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. The use of any so-called "link-chain" method will be approved only in those cases where the taxpayer can demonstrate to the satisfaction of the district director that the use of either an index method or the double-extension method would be impractical or unsuitable in view of the nature of the pool. Adequate records must be maintained by the taxpayer to support the appropriateness, reliability and suitability of an index or link-chain method.

Section 1.472-8(e)(2)(ii) provides that the total current-year cost of items making up a pool may be determined by reference to the actual cost of the goods most recently purchased or produced; by reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisitions; by application of an average unit cost, equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced; or pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

Section 1.472-8(e)(2)(iii) provides that under the double-extension method a base-year unit cost 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 of the entering item shall be the current-year cost of that item unless the taxpayer is able to reconstruct or otherwise establish a different cost. If the entering item is a product or a raw material not in existence on the base date, its cost may be reconstructed, that is, the taxpayer using reasonable means may determine what the cost of the item would have been had it been in existence in the base year. If the item was in existence on the base date, but not stocked by the taxpayer, he may establish, by using available data or records, what the cost of the item would have been to the taxpayer had he stocked the item. If the base-year unit cost of the entering item is either reconstructed or otherwise established to the satisfaction of the Commissioner, such cost may be used as the base-year unit cost in applying the double-extension method. If the taxpayer does not reconstruct or establish to the satisfaction of the Commissioner a base-year unit cost, but does reconstruct or establish to the satisfaction of the Commissioner the cost of the item at some year subsequent to the base year, he may use the earliest cost which he does reconstruct or establish as the base-year unit cost.

In *Amity Leather Prods. Co. v. Commissioner*, 82 T.C. 726 (1984), the Tax Court stated:

The nature of "items" in a pool must be similar enough to allow a comparison between ending inventory and base-year inventory. Because the change in the price index and the index affects the computation of increments or decrements in the LIFO inventory, the definition and scope of an item are extremely

important to the clear reflection of income. If factors other than inflation enter into the cost of inventory items, a reliable index cannot be computed. For example if a taxpayer's inventory experiences mix changes that result in the substitution of less expensive goods for more expensive goods, the treatment of those goods as a single item increases taxable income. This occurs because any inflation in the cost of an item is offset by the reduction in cost resulting from the shift to less expensive goods. Conversely, if changes in mix of the inventory result in the substitution of more expensive goods for less expensive goods, the treatment of those goods as a single item decreases taxable income because the increase in inventory costs is eliminated from the LIFO cost of the goods as if such cost increases represented inflation. 82 T.C. at 733.

ANALYSIS

Issue 1. Whether Taxpayer has correctly reconstructed the beginning of the year cost of used vehicles for purposes of computing an inflation index for its used vehicle LIFO pools.

Taxpayer acquires used vehicles produced by a variety of manufacturers. Taxpayer's ending inventory rarely contains used vehicles that are similar to any used vehicle in the beginning inventory. Consequently, Taxpayer treats each vehicle in ending inventory as a new item and reconstructs a beginning of the year cost for each vehicle.

Taxpayer used an official used car guide to reconstruct the beginning of the year cost of used vehicles in ending inventory. In ascertaining the beginning of the year cost of a used vehicle, Taxpayer referred to the values set forth in the Black Book covering the last week of the previous December (the December Black Book) for a vehicle of similar make, model, age, condition, mileage, and options. For example, if Taxpayer's used automobile pool included a 1995 Chevrolet Corvette at the end of the 1996 taxable year, Taxpayer would determine the beginning of the year cost of the 1995 Chevrolet Corvette by reference to the value of a 1994 Chevrolet Corvette (similar in option, mileage, and condition) listed in the December 1995 Black Book.

At the conference of right, Taxpayer acknowledged that it incorrectly referred to the December Black Book to reconstruct the beginning of the year cost of used vehicles. Taxpayer believes that it should have reconstructed the beginning of the year cost of used vehicles by reference to the Black Book covering the last week of its prior taxable year. The examining agent believes that Taxpayer should have reconstructed the beginning of the year cost of each used vehicle by reference to the Black Book covering the date 52 weeks prior to the date on which Taxpayer acquired the vehicle.

We believe that if Taxpayer reconstructs the beginning of the year cost of new items using the Black Book covering the last day of its prior taxable year, Taxpayer would compute an annual inflation index that exceeds the actual inflation for a 12-month period. This occurs because the value of a used vehicle generally declines until the last day of the preceding year. When the cost of a used vehicle acquired 60 to 90 days prior to the end of the taxable year is compared to the value of the preceding year's model on the last day of the preceding taxable year, the resulting index overstates the inflation that has occurred during a 12-month period.

Taxpayer's beginning of the year cost reconstruction method would not produce a cumulative inflation index that reliably measures quantity increases or decreases in the used vehicle inventory pools. When the annual index computed by Taxpayer is combined with the cumulative index and applied to the total

current-year cost of the pool, the base-year cost of the pool is understated. An understatement in the quantity of the ending inventory will overstate the taxpayer's cost of goods sold and distort taxable income.

Although the courts have not specifically addressed base-year or beginning of the year cost reconstruction, the courts have made clear that an accurate inflation index is critical to the clear reflection of income under the dollar-value LIFO method. *Amity Leather Products Co. v. Commissioner*, 82 T.C. 726, 732 (1984); *Hamilton Indus., Inc. v. Commissioner*, 97 T.C. 120, (1997). Because the cost of used vehicles generally declines over time, Taxpayer's beginning of the year cost reconstruction method for used vehicles produces an inaccurate inflation index and does not clearly reflect income. To compute an accurate and reliable inflation index for its used vehicle pools, Taxpayer must reconstruct the beginning of the year cost of each vehicle by reference to the value of the previous year's model of that particular vehicle listed in an official used car guide covering the day 52 weeks prior to the date the vehicle was actually acquired.

Issue 2. Whether Taxpayer's dual index method of valuing increments in its new and used vehicle LIFO pools clearly reflects income.

Taxpayer used a dual index method to price increments in its new and used vehicle LIFO pools. Taxpayer compared the latest acquisition costs of the goods on hand in ending inventory with the beginning of the year cost of those goods to develop an annual inflation index. This index was linked to the preceding year's cumulative index and divided into the latest acquisition cost of the ending inventory to determine the base year cost of the ending inventory. If there was an increment in terms of base-year cost for the year, the taxpayer multiplied the cumulative index from the preceding year by the base-year cost of the increment to determine the LIFO value of the increment.

The examining agent believes that Taxpayer's dual index method of valuing LIFO increments in its new and used vehicle pools does not clearly reflect income. Acceptable methods of valuing LIFO increments are based on the current-year cost (not prior-year cost) of items. Section 1.472-8(e)(2)(ii); see also, *Boecking v. Commissioner*, T.C. Memo. 1993-497, citing *Wendle Ford Sales, Inc. v. Commissioner*, 72 T.C. 447, 453-54 (1979). Taxpayer's dual index method does not clearly reflect income because it values dollar-value LIFO increments based on prior-year costs rather than current-year costs.

CAVEAT(S)

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