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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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472.00-00

Control Number: TAM-104808-98

SEP 30 1998

Taxpayer's Name:
Taxpayer's Address

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

LEGEND:

A =
B =
C =
a =
b =
c =
d =
e =
f =
g =
h =

ISSUES:

- (1) Has A transferred the a and b that it produces to B in bona fide sale transactions, or should A inventory the a and b until sold to third parties by B?
- (2) Should B maintain separate specific goods groupings for its inventory of a, b, c, and d?

- (3) Should B maintain a separate specific goods grouping for the b that B purchases from A and C and resells without further processing?

CONCLUSIONS:

- (1) Under the circumstances described below, A transfers the a and b to B in bona fide sale transactions. Therefore, A should not inventory the a and b until sold to third parties by B.
- (2) Under the circumstances described below, B may maintain one specific goods grouping for all of the b and d, and for all of the c that it produces, but must maintain separate specific goods groupings for all of the a and for all of the c that it purchases from third parties.
- (3) Under the circumstances described below, B does not need to maintain a separate specific goods grouping of the b that B purchases from A and C and resells without further processing because B's sales of b are integrally related to its processing operations.

FACTS:

B is in the e business. Two alternative processes are used in the e business, the f and g processes. Both processes ultimately produce b. Regardless of which process is used, the b has exactly the same use. The cost of producing one pound of b using the f process is approximately h percent more than producing one pound of b from the g process.

B produces d, which is used in the f process. In addition, B receives a, another material used in the f process, from A, a subsidiary of B. B mixes the d with the a and then processes the mixture into c and then into b.

C, a subsidiary of B, operates a facility that produces b using the g process. The b is transferred to B for further processing. A also produces b using the f process. The b that A produces also is transferred to B for further processing. In addition, B regularly purchases and sells a, b, and c in order to satisfy B's processing needs.

B accounts for its inventory of a, b, c, and d using the specific goods LIFO method. B uses one specific goods grouping for all of its inventory of a, b, c, and d and uses the equivalent units method of accounting to value its inventory of a, c, and d in equivalent units of b.

A does not maintain any ending inventory. Rather all of the a and b that A produces is accounted for as having been transferred to B. Title to the a is treated as having passed to B at the time it is loaded for shipment, and title to the b is treated as having passed to B at the time it is delivered to the shipping yard. A and B make monthly accounting entries reflecting these transfers.

LAW AND ANALYSIS:

Section 1.446-1(c)(1)(ii)(C) of the Income Tax Regulations provides that no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. The method used by the taxpayer in determining when income is to be accounted for will generally be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations. For example, a taxpayer engaged in a manufacturing business may account for the sales of the taxpayer's product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customers, whether or not billed, depending on the method regularly employed in keeping the taxpayer's books.

Section 1.471-1 provides that a taxpayer's inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer.

Section 472(a) of the Internal Revenue Code provides that a taxpayer may use the LIFO inventory valuation method in inventorying goods specified in an application to use such method. The change to, and use of, such method shall 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)(1) 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)(2) provides that in inventorying goods under the LIFO method, the taxpayer shall inventory them at cost.

Section 1.472-1(d) provides that, for purposes of the specific goods method, raw material in the opening inventory must be compared with similar raw material in the closing inventory. There may be several types of raw materials, depending on the character, quality, or price, and each type of raw material in the opening inventory must be compared with a similar type in the closing inventory.

Section 1.472-1(e) provides that, in the cotton textile industry, there may be different raw materials depending upon marked differences in length of staple, in color or grade of the cotton. But where different staple lengths or grades of cotton are being used at different times in the same mill to produce the same class of goods, such differences would not necessarily require the classification into different raw materials.

Section 1.472-1(f) provides that, as to the pork packing industry, a live hog is considered as being composed of various raw materials, different cuts of a hog varying markedly in price and use. Generally a hog is processed into approximately 10 primal cuts and several miscellaneous articles. However, due to similarity in price and use, these may be grouped into fewer classifications, each group being classed as one raw material.

Section 1.472-2(d) provides that goods of the specified type on hand as of the close of the taxable year in excess of what were on hand as of the beginning of the taxable year shall be included in the closing inventory, regardless of identification with specific invoices and regardless of specific cost accounting records, at costs determined pursuant to the provisions of subparagraph (1) or (2) of this paragraph, depending on the character of the transactions in which the taxpayer is engaged.

Section 1.472-2(d)(2) provides that, in the case of a taxpayer engaged in manufacturing, fabricating, processing, or otherwise producing merchandise, such costs shall be determined: (i) In the case of raw materials purchased or initially produced by the taxpayer, in the manner elected by the taxpayer under subparagraph (1) of this paragraph to the same extent as if the taxpayer were engaged in purchase and sale transactions; and (ii) In the case of goods in process, regardless of the stage to which the manufacture, fabricating, or processing may have advanced, and in the case of finished goods, pursuant to any proper method which, in the opinion of the Commissioner, clearly reflects income.

Section 1.472-3(a) provides that the LIFO inventory may be adopted and used only if the taxpayer files with his income tax return for the taxable year as of the close of which the method is first to be used a statement of his election to use such

inventory method. Such statement shall be accompanied by an analysis of all inventories of the taxpayer. In the case of a manufacturer, this analysis shall show in detail the manner in which costs are computed with respect to raw materials, goods in process, and finished goods, segregating the products (whether in process or finished goods) into natural groups on the basis of either (1) similarity in factory processes through which they pass, or (2) similarity of raw materials, or (3) similarity in style, shape, or use of finished products. Each group of products shall be clearly described.

Section 1.472-8(b)(2)(i) provides that, where a manufacturer or processor is also engaged in the wholesaling or retailing of goods purchased from others, the wholesaling or retailing operations with respect to such purchased goods shall not be considered a part of any manufacturing or processing unit.

In Rev. Rul. 79-290, 1979-2 C.B. 221, the taxpayer, at one time, manufactured or processed petroleum products from crude oil that it had purchased. At the time of the ruling, however, the taxpayer had sold its manufacturing and processing plant and continued its business activities solely as a distributor of refined petroleum products that it purchased on the open market. The taxpayer used the specific goods method and grouped all of its refined petroleum products together, whether refined from crude oil by the taxpayer or purchased as finished products. Rev. Rul. 79-290 holds that the taxpayer improperly grouped the petroleum products that it had manufactured or processed together with the petroleum products that it had purchased as finished products. The basis for the holding was that the taxpayer had not separately treated its manufacturing or processing operations from its wholesaling or retailing operations.

Rev. Rul. 83-59, 1983-1 C.B. 103, states that, in determining whether a taxpayer's sales of its "excess" inventory were bona fide arm's-length sales for federal income tax purposes, it is well settled that the economic substance of transactions, rather than their form, governs for tax purposes. It also states that the ownership of property consists of a "bundle of rights" including its free use and enjoyment, the control over it, and the right to dispose of it in any manner not contrary to existing regulatory laws. Rev. Rul 83-59 holds that a bona fide sale does not take place if the transferor of the property retains significant control over the property transferred and continues to bear the economic risk of loss.

Issue (1):

The taxpayer contends that the a and b that A produces are sold to B, and therefore, should be included in B's inventory.

The examining agent, on the other hand, contends that A should include the a and b in its inventory until the a and b are sold to third parties by B. The examining agent contends that the transfers of the a and b to B should be disregarded for federal tax purposes because there are no sales agreements or invoices reflecting the transfers and the transfers lack economic substance and only serve to provide favorable tax consequences to the taxpayer.

We believe that the transfers are bona fide sales for federal income tax purposes. A has given up physical possession of the a and b to B; B has free use and enjoyment of the a and b; and B may dispose of the a and b in any manner that it desires. In addition, B bears the economic risk of loss: If the value of the a and b decreases, or if they are destroyed, B will bear the loss, not A.

Issue (2):

The LIFO inventory valuation method, by matching the cost of the most recently purchased goods with the current sales revenue, removes from current earnings any artificial profits attributable to inflationary increases in inventory costs. Hamilton Industries, Inc. v. Commissioner, 97 T.C. 120, 130 (1991); Amity Leather Products Co. v. Commissioner, 82 T.C. 726, 732 (1984).

The specific goods method matches the cost of the most recently purchased goods with the current sales revenue in the following manner: The number of units in each ending inventory grouping is compared with the number of units in the corresponding beginning inventory grouping. If there is no change in the number of units in each of the inventory groupings, then all of the purchasing costs for the year are matched with the sales revenue for the year. If there is an increase in the number of units in any of the inventory groupings, then the purchasing costs associated with those additional units is added to the ending inventory grouping, and the remaining purchasing costs are matched with the sales revenue for the year. If there is a decrease in the number of units in any of the inventory groupings, then the costs associated with those units is added to the purchasing costs for the year, which are then matched with the sales revenue for the year.

In order for the specific goods method to remove from current earnings only "artificial profits attributable to inflationary increases in inventory costs," the units in the ending inventory must be compared with similar units in the beginning inventory. See §§ 1.472-1(d) and 1.472-3(a). This comparison of "similar" units is necessary because the method will remove from current earnings any profits attributable to increases in inventory

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costs, whether those costs are attributable to inflation or other cause.

The following example illustrates the necessity of comparing similar units in inventory under the specific goods method: Company X's beginning inventory consists of 10 widgets that cost \$5 each. Company X's purchases for the year consist of 10 gadgets at a cost of \$20 each, and its ending inventory consists of 10 gadgets. A comparison of the number of units in the ending inventory with the number of units in the beginning inventory shows that there is no change in the number of units. Therefore, all of the costs associated with the purchases for the year are matched with the sales revenue for the year. This will result in the additional purchasing costs of \$15 per unit associated with the change from widgets to gadgets being added to the cost of the units sold. This overstatement of the cost of the units sold will cause an understatement of Company X's current earnings.

This is not the intended result of removing from current earnings artificial profits attributable to inflationary increases in inventory costs, because the increase in the inventory costs in this example is not due to inflation, but due to a change from widgets to gadgets. Thus, the intended result is reached only when units from the ending inventory are compared with similar units in the beginning inventory.

To the extent that the specific goods method allows units that are not identical to be compared, it potentially allows profits attributable to non-inflationary increases in inventory costs to be removed from current earnings. The regulations under the specific goods method, however, make clear that the units do not need to be identical, but rather the units must be "similar." See §§ 1.472-1(d) and 1.472-3(a).

Initially, we believe that § 1.472-2(d)(2) requires that raw materials be grouped separately from goods in process and finished goods. Section 1.472-2(d), in describing the costing of goods on hand at the close of the year in excess of those on hand at the beginning of the year, provides in § 1.472-2(d)(2)(i) that a taxpayer engaged in manufacturing shall determine such costs for raw materials in the manner elected by the taxpayer under § 1.472-2(d)(1). Under § 1.472-2(d)(2)(ii) goods in process and finished goods are costed pursuant to any proper method, which in the opinion of the Commissioner, clearly reflects income.

Within each of the categories of raw materials, goods in process, and finished goods, similar units may be grouped together. In the case of raw materials, through two examples §§ 1.472-1(e) and (f) illustrate, the necessary degree of

similarity between units, in order for the units to be grouped together. Section 1.472-1(e) illustrates that, in the cotton textile industry, "cotton" may consist of several different groups, where there are marked differences in length of staple, in color or grade of the cotton. However, where the differences in quality and character are slight, such that the cotton may be used in the same mill to produce the same class of goods,¹ the cotton would not "necessarily" have to be classified into different groups.

The result in § 1.472-1(e) is qualified with the term "necessarily," because of the assumption that interchangeable units with slight differences in character and quality would not vary markedly in price, and could be used to produce the same finished product at approximately the same total cost (raw material cost and conversion cost). Section 1.472-1(f) illustrates that where units vary markedly in price or use, they must be grouped separately. However, where the units are similar, based upon price and use, they may be grouped together.

Section 1.472-1(f) also illustrates that, within an overall range of raw materials that differ markedly in price and/or use, there may be subsets that are similar in price and use such that they may be grouped together.

Thus, whether the a, b, c, and d in B's inventory must be separately grouped depends upon their classification as raw materials, goods in process, or finished goods, and whether they are similar.

In the present case, the b are finished goods and have identical uses. Thus, they may be grouped together. See § 1.472-3(a). The examining agent, however, contends that the b produced using the e process are different from the b produced using the f process because there are cost differences in the two processes. Even if we were to conclude that finished goods that have similar uses but dissimilar costs must be grouped separately, in the present case the units of b, whether produced using the e or f process, have sufficiently similar costs such that they may be grouped together.

The d and, except for the c acquired from third parties, the c are goods in process. Under the facts of the present case, we believe that grouping the goods in process and the finished goods

¹ "Class of goods" must be defined narrowly in this context in order for the specific goods method effectively to remove from current earnings artificial profits solely attributable to inflationary increases in inventory costs.

clearly reflects the taxpayer's income. See § 1.472-2(d)(2)(ii). Therefore, the c and d may be grouped together with the b. First, the c and d can be expressed in terms of equivalent units of b. Furthermore, since all of the c and d is converted into b and no other finished good, there is no question as to which end product goods in process relate.

The a is raw material and is substantially identical. In addition, the c purchased from third parties is raw material and is substantially identical. Although the a and c could be expressed in terms of equivalent units of b, as raw materials the a and c must be separately grouped from the goods in process and the finished goods. In addition, because the a and c have different character, quality, and price, the a must be separately grouped from the c.

The taxpayer contends that the a is not raw material.² First, the taxpayer contends that the transfer of a from A to B should be viewed as a transfer between divisions of a single corporation. See, for example, the "single entity" approach in § 1.1502-13. Under this type of approach, the taxpayer contends, the a is goods in process. We believe that for purposes of determining whether, in the hands of B, the a is raw material or goods in process the separate corporate status of A and B should be respected.

Second, the taxpayer argues that the a is goods in process because the a is not in its raw state, A having partially processed it. The a, as purchased by B, is to be used in B's e process. We believe that the a held for entry into that process is raw material.

Issue (3):

As stated above, a taxpayer using the specific goods method must separately group the goods in its inventory based upon whether the goods are similar. In addition, a taxpayer using the specific goods method must treat its manufacturing or processing operations separately from any wholesaling or retailing operations. In this case, the examining agent contends that the

² The taxpayer contends that, under its method of accounting, the a and c purchased from third parties are treated as "first sold" with the result that the a and c purchased from third parties never appears in ending inventory. We conclude that the a and c purchased from third parties are raw materials. We express no opinion regarding the propriety of the taxpayer's "first sold" method.

taxpayer must separately group the b that the taxpayer purchases from A and C and resells without further processing.

In Rev. Rul. 79-290, we stated that:

The dollar-value method provides a broader approach to the valuation of inventory as compared to the more narrow basis of valuation under the specific goods method. However, even in the broader pooling approach the regulation provides that where a manufacturer or processor is also engaged in the wholesaling or retailing of purchased goods, the wholesaling or retailing operations shall not be considered a part of any manufacturing or processing unit.

The origin of the requirement to separately treat manufacturing or processing operations from wholesaling or retailing operations is found in the pooling requirements of the dollar-value method. § 1.472-8(b)(2)(i). The concept of pooling under the dollar-value method is used to define the limits by which decreases in one item in the taxpayer's inventory may be offset by increases in a different item in the taxpayer's inventory.³ One such limitation is the Natural Business Unit (NBU). In setting forth the requirement to separately treat manufacturing and processing operations from wholesaling and retailing operations, the regulation focuses on the taxpayer's activities.

In UFE, Inc. v. Commissioner, 92 T.C. 1314, 1322 (1989), the court stated that:

The issue is, therefore, whether petitioner's purchase of finished inventory for sale to customers is a separate "natural business unit" from petitioner's manufacturing operations. The standard appropriate to this inquiry, and the one that we applied in Amity Leather, is whether petitioner is engaged in a separate trade or business. If a taxpayer conducts an activity with continuity and

³ For instance, in the example under issue (2), if widgets and gadgets were contained in the same pool under the dollar-value method but were different items, the concept of pooling would allow the substitution of gadgets for widgets. However, because of the item concept, the additional purchasing costs of \$15 per unit associated with the change from widgets to gadgets would not be added to the cost of goods sold. Thus, it is only when the concepts of pooling and item are used together that the dollar-value method removes from current earnings any artificial profits attributable to inflationary increases in inventory costs.

regularity for profit, that activity is characterized as a trade or business. Commissioner v. Groetzinger, 480 U.S. 23 (1987).

When Rev. Rul. 79-290 recognized that taxpayers using the specific goods method were required to separately treat manufacturing or processing operations from wholesaling or retailing operations, it did so based upon the same principles as set forth under the dollar-value method regulation. Thus, the requirement in the specific goods method that produced goods be separately grouped from purchased goods is based upon the taxpayer's activities.

In general, a taxpayer is engaged in the wholesaling or retailing of inventory if the taxpayer purchases and resells, rather than processes, any of the enumerated types of inventory assets, including raw materials, work in process, or finished goods. In applying this standard, however, it is necessary to recognize that, in certain circumstances, the purchase and subsequent resale of a raw material used in manufacturing or processing may be so intertwined with the taxpayer's manufacturing or processing operations that the transaction is properly accounted for as part of the specific goods groupings for that activity.

Although the obtaining of materials and the marketing of finished goods are necessary activities of a manufacturer or processor, if they are not accompanied by the activity of changing the physical form of the asset acquired, these activities are also consistent with the activities of a wholesaler or retailer. Thus, the taxpayer's physical processing activities are essential to the existence of a production activity. Therefore, a transaction that involves the purchase and resale of an inventory asset is appropriately integrated with the taxpayer's processing operations only if the taxpayer engages in the transaction to serve the taxpayer's physical processing activities.

In the present case, B requires b in geographical areas where it does not have supplies. B will normally transport b from its inventories to the areas where it is needed. However, because in certain circumstances the cost of transporting b can be prohibitive, on occasion B will purchase the b that it needs from local third parties and re-sell from its inventories what is then no longer needed to satisfy its processing needs. B consistently sells to third parties less b than it purchases from third parties. Under these circumstances, we do not believe that B has a separate wholesaling or retailing operation. Rather, we believe that B's sales of b are integrally related to its processing operations.

CAVEAT:

A copy of the Technical Advice Memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.