



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I Concept Unit

Unit Name	LIFO Pooling Requirements	
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Shelf	Inventory and IRC 263A
Book	Inventory LIFO
Chapter	Pooling

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General Overview

LIFO Pooling Requirement

Note: This practice unit updates the June 26, 2020, practice unit with the same title. The update clarifies slides 4, 10, and 12 regarding the 2014 reclassification of Table 6 of the Producer Price Index detailed reports to Table 9.

Any taxpayer permitted or required to take inventories pursuant to the provisions of IRC 471, and pursuant to the provisions of Treas. Reg. 1.471-1 to 1.471-9, inclusive, may elect to compute opening and closing inventories for those goods using the last-in first-out (LIFO) method provided by IRC 472. Under the LIFO inventory method, the taxpayer treats those goods remaining on hand at the close of the taxable year as being either:

1. included in the opening inventory of the taxable year (in the order of acquisition) to the extent needed, or
2. acquired during the taxable year.

The LIFO inventory method is not dependent upon the character of the business in which the taxpayer engages.

The taxpayer may adopt the LIFO method as of the close of any taxable year. Any taxpayer may elect to determine the cost of its LIFO inventories under the “dollar-value” LIFO method, provided the taxpayer consistently uses such method and it clearly reflects the taxpayer’s income in accordance with the rules in Treas. Reg. 1.472-8(b), *Dollar-value method of pricing LIFO inventories*.

To compute LIFO inventory, a taxpayer must group items of inventory into pools (Treas. Reg. 1.472-8(b)). The taxpayer must use the pools established in the year of the LIFO election in subsequent years, unless the taxpayer files a Form 3115 - *Application for Change in Accounting Method* that National Office Chief Counsel approves (Treas. Reg. 1.472-8(d)).

LIFO pooling requires that the taxpayer assign substantially similar items to a specific LIFO pool. The pooling rules differ by method and type of business (see examples on the next slide). The taxpayer must compute a LIFO index and LIFO reserve for each pool.

Relevant Key Factors

LIFO Pooling Requirement

Key Factors

Manufacturers can elect pools as follows:

- Natural Business Unit (NBU) Pools for Manufacturers (Treas. Reg. 1.472-8(b)(2)):
 - NBU pools are comprised of all items entering the entire inventory investment for a natural business unit of a business enterprise, unless the taxpayer elects multiple pools on their Form 970, Application to Use LIFO Inventory Method.
 - The determination of an NBU is a matter of fact.
 - A single pool cannot consist of both manufactured items and items purchased for resale, even if they are identical.
- Multiple Pools for Manufacturers (Treas. Reg. 1.472-8(b)(3)):
 - Pooled items must be substantially similar to each other.
 - Raw materials that are substantially similar may be pooled together.
 - Multiple pooling is not as common because NBU pooling would most likely result in fewer pools.
- Inventory Price Index Computation (IPIC) Pools for Manufacturers (Treas. Reg. 1.472-8(b)(4)):
 - Manufacturers may elect to establish pools for those items they account for under the IPIC method.
 - The IPIC method is based on the 2–digit commodity codes in Table 6 of the Producer Price Indexes Detailed Report, which the United States Bureau of Labor Statistics publishes monthly. Since 2014, the 2–digit commodity codes have been found in Table 9 of the Producer Price Indexes Detailed Report.

Relevant Key Factors (cont'd)

LIFO Pooling Requirement

Key Factors

Wholesalers and Retailers can elect pools as follows:

- LIFO Pooling for Wholesalers and Retailers (Treas. Reg. 1.472-8(c)):
 - A wholesaler, retailer, jobber or distributor pools its items of inventory by major lines, types or classes of goods.
 - The customary business classification of a trade is important in grouping the goods because it defines similar items for pooling. An example of a customary business classification is “grocery” in the retail industry.
 - A retailer that elects the IPIC method for a trade or business may elect to establish pools for those items it accounts for using the IPIC method.

Manufacturers, Wholesalers, and Retailers may establish pool combinations in certain circumstances as follows:

- LIFO Pool Combination Computations (Treas. Reg. 1.472-8(g)(2)(iii) & (iv)):
 - These regulations contain the procedures for combining dollar-value LIFO pools that have the same base year and those that have different base years.
 - Pool combinations occur when there are mergers, IRC 351 transactions and changes in accounting methods.

Detailed Explanation of the Concept

LIFO Pooling Requirement

Analysis	Resources
<p><u>Natural Business Unit</u></p> <p>A natural business unit pool consists of all items entering the entire inventory investment for a natural business unit of a business enterprise. When a business enterprise has only one natural business unit, the taxpayer should use one pool for all its inventories, including raw materials, goods in process, and finished goods, but taxpayers must still have separate pools for manufactured items and items purchased for resale. Whether an enterprise has more than one natural business unit is a matter of fact for the taxpayer to determine from all the circumstances. Some circumstances to consider are:</p> <ul style="list-style-type: none">▪ The natural business divisions the taxpayer adopts for internal management purposes▪ The existence of separate and distinct production facilities and processes▪ The maintenance of separate profit and loss records for separate operations are important considerations in determining what a business unit is, unless the taxpayer sets up such divisions, facilities, or accounting records merely because of differences in geographical location.	<ul style="list-style-type: none">▪ Treas. Reg. 1.472-8(b)

Detailed Explanation of the Concept (cont'd)

LIFO Pooling Requirement

Analysis	Resources
<p><u>Natural Business Units (cont'd)</u></p> <p>A processing plant is not a natural business unit if the taxpayer does not sell the product produced to others but transfers the product to another plant of the business, for further processing or incorporation into another product.</p> <p>On the other hand, if the taxpayer transfers the product of a manufacturing or processing plant to a separate and distinct division, which constitutes a natural business unit, the processing plant constitutes a separate natural business unit.</p> <p>The mere fact that the taxpayer may sell a portion of the product they manufacture to others at a certain stage of processing, or split processing of a product between locations, does not create separate business units.</p> <p>When a manufacturer or processor engages in the wholesaling or retailing of goods purchased from others, it should not consider the wholesaling or retailing operations for such purchased goods a part of any manufacturing or processing unit.</p> <p>See Examples of the Concept for some examples of natural business units.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.472-8(b)(1)

Detailed Explanation of the Concept (cont'd)

LIFO Pooling Requirement

Analysis	Resources
<p><u>Multiple Pools</u></p> <p>A taxpayer may elect to establish multiple pools for inventory items that are not within a natural business unit. Each pool must consist of a group of inventory items that are substantially similar. In determining whether such similarity exists, the taxpayer must consider all the facts and circumstances. Important considerations include (but are not limited to):</p> <ul style="list-style-type: none">▪ There is substantial similarity in the types of raw materials used or in the processing operations applied;▪ The raw materials used are readily interchangeable;▪ There is similarity in the use of the products;▪ The taxpayer consistently follows the groupings for internal accounting and management purposes; and▪ The groupings follow customary business practice in the taxpayer's industry. <p>The selection of pools in each case must also take into consideration such factors as the nature of the inventory items subject to the dollar-value LIFO method and the significance of such items to the taxpayer's business operations.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.472-8(b)(3)(i)

Detailed Explanation of the Concept (cont'd)

LIFO Pooling Requirement

Analysis	Resources
<p><u>Multiple Pools (cont'd)</u></p> <p>When the taxpayer inventories similar types of goods in natural business units and multiple pools, the Commissioner may apportion or allocate such goods among the natural business units and the multiple pools, if he determines the apportionment or allocation is necessary to clearly reflect the taxpayer's income.</p> <p>The taxpayer may use the dollar-value method of pricing LIFO inventories in conjunction with the raw materials content method authorized in Treas. Reg. 1.472-1. The taxpayer must pool together raw materials (including the raw material content of finished goods and goods-in-process) that are substantially similar in accordance with the principles for establishing multiple pools.</p> <p>However, the taxpayer may not place inventories of materials of an unlike nature into one pool, even though such materials become part of an otherwise identical finished products. For example, the taxpayer cannot place wood and plastic into one pool even though these materials become part of a chair.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.472-1▪ Treas. Reg. 1.472-8(b)(3)(ii)

Detailed Explanation of the Concept (cont'd) 4

LIFO Pooling Requirement

Analysis	Resources
<p><u>Inventory Price Index Computation (IPIC) Method</u></p> <p>A manufacturer or processor that elects to use IPIC method for a trade or business may elect to establish dollar-value pools for those items accounted for using the IPIC method.</p> <p>The dollar-value pools should be based on the 2–digit commodity codes found in Table 6 of the United States Bureau of Labor Statistics Producer Price Indexes and Percent Changes for Commodity Groupings and Individual Items, not seasonally adjusted of the “PPI Detailed Report,” which is published monthly (see https://www.bls.gov/ppi/ppi_dr.htm). In 2014, the Bureau of Labor Statistics moved the 2-digit commodity codes to Table 9, Producer price indexes for commodity and service groupings and individual items, not seasonally adjusted.</p> <p>A taxpayer electing to establish dollar-value pools may:</p> <ul style="list-style-type: none"> ▪ Combine IPIC pools that comprise less than 5 percent of the total current-year cost of all dollar-value pools to form a single miscellaneous IPIC pool, or ▪ Combine a miscellaneous IPIC pool that comprises less than 5 percent of the total current year cost of all dollar-value pools with the largest IPIC pool. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.472-8(b)(4) ▪ Treas. Reg. 1.472-8(g)(2) ▪ Treas. Reg. 1.446–1(e) ▪ United States Bureau of Labor Statistics (BLS) Producer Price Indexes and Percent Changes for Commodity Groupings and Individual Items, not seasonally adjusted

Detailed Explanation of the Concept (cont'd)

LIFO Pooling Requirement

Analysis	Resources
<p><u>Inventory Price Index Computation (IPIC) Method (cont'd)</u></p> <p>Each of these 5-percent rules is a method of accounting. A taxpayer may not change to, or cease using, either 5-percent rule without obtaining the Commissioner's consent by filing Form 3115 - Application for Change in Accounting Method. The taxpayer must determine whether a specific IPIC pool or the miscellaneous IPIC pool satisfies the applicable 5-percent rule in the year of adoption or year of change and then again, every third taxable year.</p> <p>A taxpayer must file Form 3115 before combining or separating pools and must combine or separate its IPIC pools in accordance the transition rules of Treas. Reg. 1.472-8(g)(2), Manner of Combining or Separating Dollar Value Pools.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.472-8(b)(4)▪ Treas. Reg. 1.472-8(g)(2)▪ Treas. Reg. 1.446-1(e)▪ Form 3115, Application for Change in Accounting Method

Detailed Explanation of the Concept (cont'd)

LIFO Pooling Requirement

Analysis	Resources
<p><u>Pools for Wholesalers, Retailers, Jobbers, and Distributors</u></p> <p>In general, wholesalers, retailers, jobbers, and distributors should place items of inventory into pools by major lines, types, or classes of goods. In determining such groupings, customary business classifications of the trade in which the taxpayer engages is an important consideration.</p> <p>When a wholesaler or retailer manufactures or processes goods, it must determine the pooling of the LIFO inventory for the manufacturing or processing operations in accordance with the principles for establishing pools of manufacturers and processors (discussed earlier in Relevant Key Factors).</p> <p>A retailer that elects to use IPIC computation method may elect to establish dollar-value pools for those items in one of two ways. They may use either the general expenditure categories in Table 3 of the Consumer Price Index for all Urban Consumers (https://www.bls.gov/cpi/tables/supplemental-files/home.htm) or the 2–digit commodity codes in Table 6 of the Producer price indexes detailed report, (Table 9 of the Producer Price Indexes detailed report since 2014) (https://www.bls.gov/ppi/ppi_dr.htm).</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.472-8(c)

Detailed Explanation of the Concept (cont'd) 7

LIFO Pooling Requirement

Analysis	Resources
<p><u>Audit Tips</u></p> <p>The examiner should verify the correctness, number and composition of pools the taxpayer is using during an examination of the income tax return, as discussed above. In addition, the examiner should verify the accuracy of all computations used for the pools.</p> <p>The taxpayer must maintain adequate records to support the base-year unit cost (the unit cost at the beginning of the year LIFO is elected), the current year unit cost (the unit cost at the end of the year LIFO is elected) at the date LIFO was elected, and the current-year unit cost for all items priced on the dollar-value LIFO inventory method.</p> <p>The examiner should review the taxpayers Form 970 and any subsequent Form 3115 elections filed to determine if the taxpayer is using the LIFO method they elected.</p> <p>The taxpayer must use the pool or pools selected for the year of adoption and for all subsequent taxable years unless the Commissioner requires a change to clearly reflect income, or unless the Commissioner grants permission to change as provided in Treas. Reg. 1.446-1(e).</p> <p>For taxpayers who received LIFO inventories in certain nonrecognition transactions, see Job Aid, LIFO Base Year Reconstruction for information on the authorization to change the method of pooling in certain specified cases.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.472-8(c)▪ Treas. Reg. 1.472-8(e)▪ Treas. Reg. 1.446-1(e)▪ Job Aid, LIFO Base Year Reconstruction▪ Form 970, Application to Use the LIFO Inventory Method▪ Form 3115, Application for Change in Accounting Method

Examples of the Concept

LIFO Pooling Requirement

Examples

Natural Business Unit Examples

Example 1. In one division, a corporation manufactures automatic clothes washers and driers of both commercial and domestic grade, and electric ranges and dishwashers. In another division, the corporation manufactures radios and television sets.

The manufacturing facilities and processes used in manufacturing the radios and television sets are distinct from those used in manufacturing the automatic clothes washers, driers, and electric ranges and dishwashers.

Under these circumstances, the enterprise would consist of two natural business units and two pools would be appropriate, one consisting of all the LIFO inventories used in the manufacture of clothes washers and driers, electric ranges and dishwashers and the other consisting of all the LIFO inventories used in the production of radio and television sets.

Example 2. A taxpayer produces plastics in one of its plants. The taxpayer sells substantial amounts of the plastics it produces.. The taxpayer ships the remainder of the production to a second plant of the taxpayer to produce plastic toys that it sells to customers.

The taxpayer operates the plastics plant and toy plant as separate divisions. Because of the different product lines and the separate divisions, the taxpayer has two natural business units.

Example 3. A taxpayer manufactures paper. At one stage of processing, it produces and sells substantial amounts of uncoated paper. The taxpayer transfers the remainder of the uncoated paper to the taxpayer's finishing mill where it produces and sells coated paper.

This taxpayer has only one natural business unit since coated and uncoated paper are within the same product line.

Examples of the Concept (cont'd)

LIFO Pooling Requirement

Examples

Multiple Pools Example

A defense contractor with multiple business lines can establish multiple pools for its inventory based on customary business classifications such as vehicles, weapons, ammunition, ships or aircraft.

IPIC Method Example

A specialty retailer for women's clothes should use IPIC Code of 03 for Textiles and Apparel based on the 2-Digit IPIC Code derived from Bureau of Labor Statistics ("BLS") Consumer's Price Index (CPI Table 3). The retailer should assign all the inventory items in the pool to the most detailed BLS Category; e.g., 03810623 for Separate Skirts, 03810601 for Knit Shirts, 03810602 for Woven Shirts, etc.

Pools for Wholesalers, Retailers, Jobbers, and Distributors Example

Wholesalers, Retailers, Jobbers, and Distributors may use customary business classifications such as departments within a department store. In such case, practices are relatively uniform throughout the trade, and the taxpayer adapts departmental grouping to the business's customs and needs. A retail grocery store's pools may include grocery, dairy, produce, meat, bakery, health and beauty (HBC), hard lines, soft lines and pharmacy.

However, in appropriate cases, the taxpayer may use pooling by natural business units with the Commissioner's permission by properly filing a Form 970 or Form 3115.

Index of Referenced Resources

LIFO Pooling Requirement
IRC 351
IRC 472
Treas. Reg. 1.446-1(e)
Treas. Reg. 1.471-1
Treas. Reg. 1.472-8(b)
Treas. Reg. 1.472-8(c)
Treas. Reg. 1.472-8(e)
Treas. Reg. 1.472-8(g)
Form 970, Application to Use the LIFO Inventory Method
Form 3115, Application for Change in Accounting Method
Job Aid, LIFO Base Year Reconstruction
United States Bureau of Labor Statistics (BLS) Producer Price Indexes and Percent Changes for Commodity Groupings and Individual Items, not seasonally adjusted

Training and Additional Resources

LIFO Pooling Requirement	
Type of Resource	Description(s)
Issue Toolkits	<ul style="list-style-type: none"> ▪ Issue Snapshot, LIFO IPIC Pools for Manufactured Goods and Goods Purchased for Resale ▪ Issue Snapshot, LIFO Pooling under Dollar Value Method ▪ Issue Snapshot, Establishing Pools under the Dollar Value LIFO Method ▪ Issue Snapshot, Representative Sample Allowed to Compute a LIFO Index
White Papers / Guidance	<ul style="list-style-type: none"> ▪ Issue Paper, Manufacturer Natural Business Unit Pooling Goods Purchased for Resale ▪ Issue Paper, LIFO Pooling Finished Goods Separate from Manufactured Goods ▪ FAA 20080401F, Petroleum Refiner Item Definition for Dollar-value LIFO ▪ TAM 9129004, The Service found that a taxpayer's use of one NBU representing all its domestic manufacturing and distribution operations to be inappropriate under Treas. Reg. 1.472-8(b)(2)
Other Training Materials	<ul style="list-style-type: none"> ▪ Basic LIFO Inventory PPT, 2012-03 ▪ IPIC LIFO PPT, 2012-03 ▪ Overview of IPIC method and BLS Reports PPT, 2015-04

Glossary of Terms and Acronyms

Term/Acronym	Definition
BLS	United States Bureau of Labor Statistics
CPI	Consumer Price Index
IPIC	Inventory Price Index Computation
IRC	Internal Revenue Code
FIFO	First In-First Out
LIFO	Last In-First Out
NBU	Natural Business Unit
PPI	Producer Price Index
Treas. Reg.	Treasury Regulation

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
	None at this time