INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-119879-05 (CC:ITA:6)

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
BBBB =
ZZZZ =
Date 1 =
Date 2
Date 3
Date 4
Date 5
Date 6
Date 7
Date 8
Date 9
AA
BB
CC

DD
EE
FF
GG
HH
II
JJ
KK
LL
MM
NN
OO
PP
QQ
RR
SS
TT
UU
VV
WW

ISSUES:

(1) Having elected to use the dollar-value, last-in, first-out ("LIFO") method under § 1.472-8 of the Income Tax Regulations, must Taxpayer use the LIFO method to account for all items that fall within its dollar-value pools?

(2) Should the national office revoke the letter ruling that permits Taxpayer's BBBB segment to use a non-LIFO method to account for some of the items that fall within its pools? If yes, is Taxpayer entitled under section 7805(b)(8) of the Internal Revenue Code to have this revocation applied without retroactive effect?

(3) Should the national office revoke the automatic change in accounting method obtained by Taxpayer's ZZZZ segment under section 10.07 of the Appendix of Rev. Proc. 2002-9, 2002-1 C.B. 327 (*i.e.*, change to "IPIC-method" pools described in § 1.472-8(c)(2)) and require Taxpayer's ZZZZ segment to revert to its former method of pooling? If yes, is Taxpayer's ZZZZ segment entitled under section 7805(b)(8) to have this revocation applied without retroactive effect?

CONCLUSIONS:

(1) The scope of Taxpayer's LIFO election must extend to all items the fall within Taxpayer's pools.

(2) The national office should, and does, revoke Taxpayer's letter ruling. But Taxpayer's BBBB segment is entitled under section 7805(b)(8) to have the revocation of its letter ruling applied without retroactive effect.

(3) The national office should, and does, revoke Taxpayer's automatic change in accounting method. But Taxpayer's ZZZZ segment is entitled under section 7805(b)(8) to have the revocation of its change in accounting method applied without retroactive effect.

FACTS:

Overview

As a consolidated group, Taxpayer operates several lines of business, including a ZZZZ segment and a BBBB segment. To identify the items in some of its inventories, Taxpayer uses the dollar-value LIFO method. For these inventories, Taxpayer uses the inventory price index computation ("IPIC") method to price its dollar-value pools. Taxpayer maintains IPIC-method pools based on the product groupings established by the Bureau of Labor Statistics ("BLS"). Specifically, Taxpayer's ZZZZ segment maintains pools based on the 2-digit commodity codes in Table 6 of the Producer Price Index ("PPI") Detailed Report, and Taxpayer's BBBB segment maintains pools based on the general expenditure categories in Table 3 of the Consumer Price Index ("CPI") Detailed Report. To account for its non-LIFO inventories, Taxpayer's BBBB segment values items at cost or market, whichever is lower, ("LCM") computed under the first-in, first-out ("FIFO") method. *See* §1.471-4. Taxpayer's ZZZZ segment values items at approximate LCM ("retail LCM") under the retail inventory method. *See* § 1.471-8. The two following sections contain a detailed history of Taxpayer's method changes.

ZZZZ Segment

Effective for the tax year ending Date 1, Taxpayer elected to use the retail LIFO method to account for all the inventories of its ZZZZ segment. *See* § 1.472-1(k). Taxpayer maintained pools based on the groups listed in "Department Store Inventory Price Indexes" and used BLS Department Store Inventory Price Indexes ("DSIP indexes") to price these pools. Taxpayer used this method through the tax year ending Date 4.

Effective for the tax year ending Date 6, Taxpayer obtained the Commissioner's consent to value at retail LCM all items that fall within Pool 5, Pool 6, and Pool 15. Pool 5 is maintained for Department 5 (AA) and Department 55 (AA). Pool 6 is maintained for Department 6 (BB). Finally Pool 15 is maintained for Department 15 (CC). Taxpayer has complied with the terms and conditions of the signed consent agreement.

Effective for the tax year ending Date 9, Taxpayer obtained the Commissioner's consent to value at retail LCM all items that fall within Pool 3, Pool 7, Pool 9, and Pool

16. Pool 3 is maintained for Department 3 (DD; EE), Department 4 (FF), and Department 53 (GG). Pool 7 is maintained for Department 7 (HH), Department 43 (HH), and Department 57 (HH, II). Pool 9 is maintained for Department 9 (JJ), Department 45 (JJ), Department 48 (JJ), and Department 51 (JJ). Pool 16 is maintained for Department 16 (KK), Department 56 (LL), and Department 84 (MM). Taxpayer has complied with the terms and conditions of the signed consent agreement. After implementing this change, Taxpayer still maintained 29 pools for the LIFO inventories of 39 departments.

Also effective for the tax year ending Date 9, Taxpayer obtained automatic consent to change its LIFO method in three respects. First, for Pool 1, Taxpayer ceased using an internal index and began using the IPIC method based on the PPI Detailed Report. Second, for Pools 2 through 40, Taxpayer ceased using the DSIP indexes and began using the IPIC method based on the PPI Detailed Report. Third, Taxpayer changed to IPIC-method pools based on the 2-digit commodity code in Table 6 of the PPl Detailed Report. With its tax return for the year of change, Taxpayer included Form 970, Application To Use LIFO Inventory Method, and two supporting statements. In the first supporting statement, Taxpayer elected to use the IPIC method for "the following goods already on LIFO" and listed the departments whose inventories are covered by the election. This list excluded those departments whose inventories are valued at LCM under the FIFO method. In the second supporting statement, Taxpayer asserted that it will not use the IPIC method for those departments for which it does not use the LIFO method.

As the result of the partial terminations of Taxpayer's LIFO election and the change to IPIC-method pools, Taxpayer uses two methods of valuing, and accounting for, items that fall within some of its pools. Specifically, Taxpayer values some of the items at approximate cost computed under the retail LIFO method and values the other items at retail LCM computed under the retail method.

BBBB Segment

Effective for the tax year ending Date 2, Taxpayer elected to use the dollar-value LIFO method (but not the retail method) to account for the inventories of its BBBB segment. Taxpayer established seven pools based on the categories in Tables 3 and 5 of the CPI Detailed Report: (1) Pool 1 (2) Pool 4 ; (3) Pool 5 ; (4) Pool 6 (5) Pool 8 ; (6) Pool 9 ; and (7) Pool 10 .

Effective for the tax year ending Date 3, Taxpayer obtained the Commissioner's consent under former § 1.472-8(e)(3) (T.D. 7814, 1982-2 C.B. 84) to change its LIFO method in two respects. First, Taxpayer ceased computing internal indexes and began using the IPIC method ("old IPIC method"). Second, Taxpayer began maintaining seven pools based on the 11 general expenditure categories in Table 3 of the CPI

Detailed Report: (1) Pool 1 ; (2) Pool 4 ; (3) Pool 5 ; (4) Pool 6 ; (5) Pool 8 ; (6) Pool 9 ; and (7) Pool 10 .

Taxpayer has complied with the terms and conditions of the signed consent agreement.

Effective for the tax year ending Date 6, Taxpayer obtained the Commissioner's consent to terminate its LIFO election for five categories of items that fall within Pool 4 and to value these items at LCM computed under the FIFO method. The five categories of items are: (1) Category 5 (AA); (2) Category 6 (NN); (3) Category 30 (OO); (4) Category 31 (PP); and (5) Category 60 (QQ). The cost of these five categories of items represents 48.96 percent of Pool 4's total cost. Taxpayer has complied with the terms and conditions of the signed consent agreement. In its Form 3115, Application for Change in Accounting Method, which was signed by Taxpayer on Date 5, Taxpayer listed its pools. Specifically, after Pool 8, Taxpayer listed Pool 9/10, which is denoted " ." The categories of items that fall within Pool 9/10 are: (1) Category 45 (RR); (2) Category 2 (SS); (3) Category 83 (SS); and (4) Category 88 (SS).

Also effective for the taxable year ending Date 6, Taxpayer obtained the Commissioner's consent to change its method of pooling in two respects. First, Taxpayer created two new pools under § 1.472-8(c) (concerning customary business classifications of the taxpayer's trade or business). Specifically, Taxpayer added Pool 11 and Pool 12 . Second, Taxpayer changed its existing pools because the BLS revised the general expenditure categories of the CPI Detailed Report. The only categories of Pool 4 that were affected by these changes were Category 69 (TT) and Category 3 (UU). Category 69 was separated from Pool 4 and combined with Pool 8 (now,), and Category 3 was separated from Pool 4 and combined with new Pool 11. Besides the previous changes affecting Pool 4, Category 55 (VV) was separated from Pool 5 and added to new Pool 11, and Category 29 (WW) was separated from Pool 8 and added to new Pool 12. Taxpayer has complied with the terms and conditions of the signed consent agreement. In its second Form 3115, which was signed by Taxpayer on Date 7, Taxpayer listed Pool 9 and Pool 10 as separate pools denoted The category of items that falls within Pool 9 is Category 45, and the categories of items that fall within Pool 10 are: (1) Category 2; (2) Category 54 (SS); (3) Category 83; and (4) Category 88. Thus, Taxpayer has four pools denoted "Other Goods & Services."

Effective for the tax year ending Date 8, Taxpayer obtained the Commissioner's consent to terminate its LIFO election for all items in Category 29 (WW). Taxpayer has complied with the terms and conditions of the signed consent agreement. In its Form 3115, Taxpayer listed its pools. Specifically, Taxpayer listed Pool 9/10/11/12, which is denoted Pool 9/10/11/12 is a miscellaneous pool under former § 1.472-8(e)(3)(iv). The categories of items that fall within Pool 9/10/11/12 are:

(1) Category 45; (2) Category 2; (3) Category 27 (SS); (4) Category 54; (5) Category 83; and (6) Category 88.

Effective for the tax year ending Date 9, Taxpayer obtained automatic consent to change from the old IPIC method to the IPIC method under § 1.472-8(e)(3).

As the result of the partial terminations of Taxpayer's LIFO election and the use of IPIC-method pools, Taxpayer uses two methods of valuing, and accounting for, items that fall within some of its pools. Specifically, Taxpayer values some of the items at cost computed under the LIFO method and values the other items at LCM computed under the FIFO method.

LAW AND ANALYSIS:

Section 472(a) provides that a taxpayer may use the method provided in section 472(b) (whether or not such method has been prescribed under section 471) in inventorying goods specified in an application to use such method filed at such time and in such manner as the Secretary may prescribe. The change to, and the 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 1.472-1(a) provides that any taxpayer permitted or required to take inventories pursuant to the provisions of section 471, and pursuant to the provisions of §§ 1.471-1 to 1.471-9, inclusive, may elect with respect to those goods specified in his application and properly subject to inventory to compute his opening and closing inventories in accordance with the method provided by section 472, this section, and § 1.472-2.

Section 1.472-3(c) provides that as a condition to the taxpayer's use of the LIFO inventory method, the Commissioner may require that the method be used with respect to goods other than those specified in the taxpayer's statement of election if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income.

Section 1.472-8(a) provides that any taxpayer may elect to determine the cost of his LIFO inventories under the so-called "dollar-value" LIFO method, provided such method is used consistently and clearly reflects the income of the taxpayer in accordance with the rules of this section. 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. Under such method the goods contained in the inventory are grouped into a pool or pools as described in paragraphs (b) and (c) of this section. The term "base-year cost" is the aggregate of the cost (determined as of the beginning of the taxable year for which the LIFO method is first adopted, i.e., the base date) of all items in a pool. The taxable year for which the LIFO method is first adopted with respect to

any item in the pool is the "base year" for that pool, except as provided in paragraph (g)(3) of this section. Liquidations and increments of items contained in the pool shall be reflected only in terms of a net liquidation or increment for the pool as a whole. Fluctuations may occur in quantities of various items within the pool, new items which properly fall within the pool may be added, and old items may disappear from the pool, all without necessarily effecting a change in the dollar value of the pool as a whole. An increment in the LIFO inventory occurs when the end of the year inventory for any pool expressed in terms of base-year cost is in excess of the beginning of the year inventory for that pool expressed in terms of base-year cost. In determining the inventory value for a pool, the increment, if any, is adjusted for changing unit costs or values by reference to a percentage, relative to base-year-cost, determined for the pool as a whole.

Section 1.472-8(b)(1) provides that a pool shall consist of all items entering into the entire inventory investment for a natural business unit of a business enterprise, unless the taxpayer elects to use the multiple pooling method provided in § 1.472-8(b)(3). Thus, if a business enterprise is composed of only one natural business unit, one pool shall be used for all of its inventories, including raw materials, goods in process, and finished goods. If, however, a business enterprise is actually composed of more than one natural business unit, more than one pool is required. Where similar types of goods are inventoried in two or more natural business units of the taxpayer, the Commissioner may apportion or allocate such goods among the various natural business units, if he determines that such apportionment or allocation is necessary in order to clearly reflect the income of such taxpayer.

Section 1.472-8(b)(3)(i)(*a*) provides, in relevant part, that a taxpayer may elect to establish multiple pools for inventory items which are not within a natural business unit as to which the taxpayer has adopted the natural business unit method of pooling as provided in § 1.472-8(b)(1). Each such pool shall ordinarily consist of a group of inventory items which are substantially similar. . . . 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. Where similar types of goods are inventoried in natural business units and multiple pools of the taxpayer, the Commissioner may apportion or allocate such goods among the natural business units and the multiple pools, if he determines that such apportionment or allocation is necessary in order to clearly reflect the income of the taxpayer.

Section 1.472-8(c)(1) provides, in relevant part, that items of inventory in the hands of wholesalers, retailers, jobbers, and distributors shall be placed into pools by major lines, types, or classes of goods. In determining such groupings, customary business classifications of the particular trade in which the taxpayer is engaged is an important consideration. An example of such customary business classification is the department in the department store.

Section 1.472-8(c)(2) provides, in relevant part, that a retailer that elects to use the IPIC method for a trade or business may elect to establish dollar-value pools for those items accounted for using the IPIC method based on either the general expenditure categories (i.e. major groups) in Table 3 (Consumer Price Index for all Urban Consumers (CPI-U): U.S. city average, detailed expenditure categories) of the "CPI Detailed Report" or the 2-digit commodity codes (i.e., major commodity groups) in Table 6 (Producer price indexes and percent changes for commodity groupings and individual items, not seasonally adjusted) of the "PPI Detailed Report."

Rev. Rul. 76-282, 1976-2 C.B. 137, holds that the taxpayer's right to select the class or classes of goods to be covered by the LIFO election (or extension) goes to the nature of the goods and not to their condition, salability, or other characteristics. Therefore, when the LIFO method is elected (or extended) for a particular class of goods, the election must include all goods within that class regardless of whether they are normal goods or goods that are unsalable at normal prices or unusable in the normal way.

Section 10.01 of Rev. Proc. 97-27, 1997-1 C.B. 680*,* 690, provides that a taxpayer that changes to a method of accounting pursuant to this revenue procedure may be required to change or modify that method of accounting for the following reasons: (1) the enactment of legislation; (2) a decision of the United States Supreme Court; (3) the issuance of temporary or final regulations; (4) the issuance of a revenue ruling, revenue procedure, notice, or other statement published in the Internal Revenue Bulletin; (5) the issuance of written notice to the taxpayer that the change in method of accounting was granted in error or is not in accord with the current views of the Service; or (6) a change in the material facts on which the consent was based.

Section 10.02 of Rev. Proc. 97-27 provides that except in rare or unusual circumstances, if a taxpayer that changes its method of accounting under this revenue procedure is subsequently required under this section 10 to change or modify that method of accounting, the required change or modification will not be applied retroactively provided that: (1) the taxpayer complied with all the applicable provisions of the Consent Agreement and this revenue procedure; (2) there has been no misstatement or omission of material facts; (3) there has been no change in the material facts on which the consent was based; (4) there has been no change in the applicable law; and (5) the taxpayer to whom consent was granted acted in good faith in relying on the consent, and applying the change or modification retroactively would be to the taxpayer's detriment.

Section 11.01 of Rev. Proc. 97-27 provides that the district director must apply a ruling obtained under this revenue procedure in determining the taxpayer's liability unless the district director recommends that the ruling should be modified or revoked. The district director will ascertain if: (1) the representations on which the ruling was based reflect an accurate statement of the material facts; (2) the amount of the § 481(a) adjustment was properly determined; (3) the change in method of accounting was

implemented as proposed in accordance with the terms and conditions of the Consent Agreement and this revenue procedure; (4) there has been any change in the material facts on which the ruling was based during the period the method of accounting was used; and (5) there has been any change in the applicable law during the period the method of accounting was used.

Section 11.02 of Rev. Proc. 97-27 provides that if the district director recommends that the ruling (other than the amount of the § 481(a) adjustment) should be modified or revoked, the district director will forward the matter to the national office for consideration before any further action is taken. Such a referral to the national office will be treated as a request for technical advice, and the provisions of Rev. Proc. 97-2 (or any successor) will be followed.

Section 9.03 of Rev. Proc. 2002-9 provides that if the director recommends that a change in method of accounting (other than the § 481(a) adjustment) made in compliance with all the applicable provisions of this revenue procedure should be modified or revoked, the director will forward the matter to the national office for consideration before any further action is taken. Such a referral to the national office will be treated as a request for technical advice, and the provisions of Rev. Proc. 2001-2 (or any successor) will be followed.

Section 10.01(1)(a)(i) of the Appendix of Rev. Proc. 2002-9 provides, in relevant part, that a taxpayer may change from the LIFO inventory method for all its LIFO inventories or for a pool or pools within its LIFO inventory.

Section 15.06 of Rev. Proc. 2005-2, 2005-1 I.R.B. 86, 112, provides generally that in the case of a TAM or a TEAM revoking or modifying a letter ruling, TAM or TEAM, the TAM or the TEAM will be applied retroactively to the taxpayer for whom the letter ruling was issued or to a taxpayer whose tax liability was directly involved in a letter ruling, TAM, or TEAM if: (1) there has been a misstatement or omission of controlling facts; or (2) the facts at the time of the transaction are materially different from the controlling facts on which the letter ruling, TAM or TEAM was based. Generally, in all other circumstances, a TAM or a TEAM revoking or modifying a letter ruling or another TAM or TEAM will not be applied retroactively to the taxpayer for whom the letter ruling, TAM, or TEAM was issued or to a taxpayer whose tax liability was directly involved in the letter ruling, TAM, or TEAM, provided that: (1) there has been no change in the applicable law; (2) in the case of a letter ruling, it was originally issued for a proposed transaction; and (3) the taxpayer directly involved in the letter ruling, TAM, or TEAM acted in good faith in relying on the letter ruling, TAM, or TEAM and revoking or modifying it retroactively would be to the taxpayer's detriment. For example, the tax liability of each shareholder in a corporation is directly involved in a letter ruling on the reorganization of the corporation. The tax liability of a member of an industry is not directly involved in a letter ruling, TAM, or TEAM issued to another member and, therefore, the holding in a revocation or modification of a letter ruling, TAM, or TEAM to one member of an industry may be retroactively applied to other

members of the industry. By the same reasoning, a tax practitioner may not extend to one client the non-retroactive application of a revocation or modification of a letter ruling, TAM, or TEAM previously issued to another client. When a letter ruling to a taxpayer or a TAM or a TEAM involving a taxpayer is modified or revoked with retroactive effect, the notice to the taxpayer, except in fraud cases, sets forth the grounds on which the modification or revocation is being made and the reason why the modification or revocation is being applied retroactively.

Issue 1: Having elected to use the dollar-value LIFO method under § 1.472-8, must Taxpayer use the LIFO method to account for all items that fall within its dollar-value pools?

Discussion:

Exam believes that Taxpayer's inventory method does not clearly reflect income because Taxpayer does not use the LIFO method to account for all items that fall within its IPIC-method pools. Taxpayer instead values some of these items at either LCM computed under the FIFO method (BBBB segment) or retail LCM computed under the retail method (ZZZZ segment). The first effect of Taxpayer's inventory method is to increase the inventory price index ("IPI") of the affected pools because the falling cost of the items valued at LCM and retail LCM does not offset the rising cost of the other items in Taxpayer's pools. In other words, each pool's inflation rate is overstated because the items whose replacement cost is falling are excluded. The second effect of Taxpayer's inventory method is to increase Taxpayer's cost of goods sold and, thus, to reduce Taxpayer's taxable income. To ensure that Taxpayer's inventory method clearly reflects income, Exam proposes to require under § 1.472-3(c) Taxpayer to use the LIFO method for all items that fall within Taxpayer's IPIC-method pools.

In contrast, Taxpayer has offered three rationales to support its view that it is not required to use the LIFO method to account for all items that fall within its IPIC-method pools. First, according to Taxpayer, no general rule or concept prohibits Taxpayer from using the LIFO method to account for some inventory items and using the FIFO method to account for the balance of its inventory items. Second, the IPIC-method pooling regulations do not specifically require Taxpayer to extend the scope of its LIFO election to include all items that fall within its IPIC-method pools. Third, because Taxpayer properly applies the rules governing IPIC-method pools, and because Taxpayer's LIFO computations otherwise clearly reflect income, Exam does not have the authority to change Taxpayer's inventory method. We will discuss each of these rationales in turn.

To prove its first rationale, Taxpayer argues that the Service sometimes requires a taxpayer to use the LIFO and FIFO methods for different items that fall within the same pool and cited TAM 9515001 (Nov. 18, 1994), TAM 8106014 (Oct. 29, 1980), and PLR 200106036 (Feb. 9, 2001) as examples of those instances. Taxpayer contends that the rationale used in these rulings is simple, clear, and based on the principle of section 472(a), namely, that the scope of a taxpayer's LIFO election is limited to the

items specified in the taxpayer's Form 970. Next, Taxpayer argues that a taxpayer may limit the scope of its LIFO election to some (but not all) of the costs of specified goods. *See* §§ 1.472-1(c); 1.472-8(b)(3)(ii).

We disagree first with Taxpayer's argument that the Service sometimes requires a taxpayer to use the LIFO and FIFO methods for different items that fall within the same pool. None of the rulings cited by Taxpayer supports Taxpayer's argument. In TAM 9515001, the national office held that a taxpayer whose LIFO election specified "new automobiles" had properly elected LIFO for its new automobiles but had not properly elected LIFO for its new trucks. This taxpayer actually had used the LIFO method for both new automobiles and new trucks and had separately pooled those automobiles and trucks in accordance with *Fox Chevrolet, Inc. v. Commissioner*, 76 T.C. 708 (1981), *acq*. 1984-2 C.B. 1. Because automobiles and trucks are not includible in the same pool, TAM 9515001 does not stand for the proposition that a taxpayer may use the LIFO method to account for some (but not all) of the items that fall within a pool. In TAM 8106014, the national office held that a manufacturer had not elected to adopt the LIFO method for the inventories of newly acquired Division D. The manufacturer acquired several businesses from 1973 through 1976, treated each acquisition as a separate division, and generally filed a Form 970 for each year that it acquired a new business. The manufacturer acquired Division C in 1975 and 1976, but did not file a Form 970 for 1975 because the difference between Division C's inventories computed under the LIFO and FIFO methods was immaterial. The manufacturer acquired Division D in 1976. On the Form 970 for 1976, the manufacturer indicated its intent to use the LIFO method to account for all the inventories of Division C, but did not mention the inventories of newly acquired Division D. Because each acquired business arguably was a separate trade or business under section 446(d) and, thus, was permitted to have its own methods of accounting, TAM 8106014 does not stand for the proposition that a taxpayer may use the LIFO method to account for some (but not all) of the items that fall within a pool. Finally, in PLR 200106036, the national office exercised its discretion under § 301.9100-1(c) of the Procedure and Administration Regulations to grant a taxpayer additional time to file a second Form 970. The taxpayer actually used the LIFO method to account for its new machinery inventories and new B parts inventories, even though the taxpayer failed to indicate on its Form 970 that the LIFO election extended to its new B parts inventories.[1] Thus, PLR 200106036 does not stand for the proposition that a taxpayer may use the LIFO method to account for some (but not all) of the items that fall within a pool.

We disagree second with Taxpayer's argument that its inventory method is analogous to the raw-material-content method under § 1.472-1(c), which permits a manufacturer to limit the scope of its LIFO election to raw materials, the raw material content of work-in-process, and the raw material content of finished goods. The raw-

[1] Because TAM 9515001 was not a ruling, the national office declined to state whether the automobile / truck dealer was entitled to relief under § 301.9100-1.

material-content method is an express exception to the general rule that requires total product costing. Furthermore, a taxpayer using the raw-material-content method must include in its pool all substantially similar raw materials, the raw material content of work-in-process, and the raw material content of finished goods. *See* § 1.472-8(b)(3)(ii). Thus, a taxpayer may not value the raw material content of finished goods at LCM after excluding it from its raw-material-content pool.

To prove its second rationale, Taxpayer argues that the final regulations governing the IPIC method liberalized the rules concerning the scope of the IPIC-method election because of criticism received from commentators. Taxpayer cites § 1.472-8(e)(3)(ii), which generally limits a taxpayer's IPIC-method election to a trade or business, and § 1.472-8(c)(2), which provides, in relevant part, that a retailer that elects to use the IPIC method for a trade or business may elect to establish dollar-value pools for those items accounted for using the IPIC method.

We disagree with Taxpayer's interpretation of the new regulations. First, though § 1.472-8(e)(3)(ii) was drafted to be consistent with section 446(d), which permits a taxpayer to use different methods of accounting for each trade or business, § 1.472-8(e)(3)(ii) does not override §1.472-2(i), which allows the Service to extend the scope of a taxpayer's LIFO election to a different trade or business when necessary to clearly reflect the taxpayer's income. Second, the seemingly restrictive language in § 1.472-8(c)(2) was drafted to permit resellers to use DSIP pools for the part of their LIFO inventories that is covered by DSIP indexes and to use IPIC-method pools for the remainder of their LIFO inventories. In other words, this language was not drafted to limit the scope of a taxpayer's LIFO election.

To support its third rationale, Taxpayer argues that when computing each pool's IPI for the taxable year, Taxpayer uses only BLS price indexes provided for the items it includes in the pool. Thus, each pool's IPI accurately reflects the inflation or deflation associated with the items that Taxpayer included in the pool. In addition, Taxpayer argues that § 1.472-3(c) is inapplicable because Taxpayer's inventory method clearly reflects income. In Taxpayer's view, its inventory method clearly reflects income because Taxpayer complied with the regulations governing IPIC-method pools and properly computed each pool's IPI.

We disagree with Taxpayer's analysis because it begs the question of whether the scope of Taxpayer's LIFO election must include all items that fall within Taxpayer's IPIC-method pools. As indicated above, the seemingly restrictive language in § 1.472-8(c)(2) does not resolve this issue. More important, taxpayers using an impermissible method generally perform the required arithmetic computations properly, but this fact does not convert an impermissible method into a permissible method. For example, in Rev. Rul. 76-282, the Service did not reject the taxpayer's proposed LIFO method because of improper arithmetic computations. Thus, the fact that Taxpayer properly computed each pool's IPI under its inventory method cannot prevent the Service from invoking § 1.472-3(c).

In our view, the scope of a taxpayer's LIFO election must include all items that fall within its pools. Though § 1.472-8 does not explicitly link the scope of the taxpayer's LIFO election and the method of pooling selected by the taxpayer ("linkage"), we believe that the LIFO method will not clearly reflect income without this linkage. Our belief is based on the history, purpose, and application of the dollar-value LIFO method and is consistent with our rule that permits a partial termination of a LIFO election on a pool-by-pool basis. *See, e.g.,* section 10.01(1)(a)(i) of the Appendix of Rev. Proc. 2002-9.

Under § 1.472-8(a), the dollar-value LIFO method is a method of determining the cost of a pool of properly assigned goods. The dollar-value LIFO method was created to remedy the most problematic aspect of using the specific-goods LIFO method, namely, the requirement to apply the specific-goods LIFO method to each inventory "group," which consists of very similar, if not identical, goods. A taxpayer using the specific-goods LIFO method must analyze its inventories to determine which goods are very similar to each other, must assign all very similar goods to a group, and must separately account for each group. But this classification process is problematic for both the taxpayer and the Service because Good A1 can be very similar to Good A2 or to Good B1, or both, depending on the criterion or criteria used to determine similarity. Because pools under the dollar-value LIFO method generally are defined more broadly than groups under the specific-goods LIFO method, the use of pools reduces this classification problem and enables taxpayers selling a large variety of goods to use the LIFO method. Furthermore, the dollar-value LIFO method reduces the probability that the LIFO cost of an item will be liquidated when the taxpayer's inventory mix shifts to another item within the same class of goods.

A taxpayer using the dollar-value LIFO method treats all the goods that fall within a pool as fungible for inventory-accounting purposes. Instead of measuring changes in the number of units of specific goods in ending inventories, the taxpayer computes, for the pool as a whole, the net change in inventory investment (increment or decrement) measured in base-year dollars. Thus, the LIFO cost of a pool will not necessarily change even though the taxpayer increases or decreases the quantity of the various goods that properly fall within the pool, adds new items that properly fall within the pool, or deletes old items from the pool. Furthermore, because a taxpayer treats as fungible all goods that fall within a pool, the taxpayer is not required to extend its LIFO election each time it manufactures or acquires a new item that falls within an existing pool.

We believe that the linkage requirement underlies the rules in § 1.472-8(b) and (c) (concerning dollar-value pools) and Rev. Rul. 76-282, which applies to taxpayers using either specific-goods LIFO or dollar-value LIFO. Furthermore, we find nothing in this published guidance suggesting that IPIC-method pools have been exempted from the linkage requirement.

Section 1.472-8(b)(1) provides two explicit rules concerning the pools of a manufacturer's natural business unit ("NBU"). First, a manufacturer must include in its

single NBU pool the entire inventory investment (*i.e.*, raw materials, work-in-process, and finished goods) of its NBU. This rule, which reflects an inventory-investment concept, prevents the manufacturer from distorting income by using the LIFO method to account for some (but not all) of the NBU's inventory. Though this rule also permits the manufacturer to change the mix of items in an NBU pool as market conditions change, substituting one item for another will not distort the manufacturer's income because § 1.472-8(b)(2) defines "NBU" narrowly to ensure that the items manufactured by the NBU ("manufactured items") have similar physical and cost characteristics. Second, a manufacturer may not include in an NBU pool any items purchased for resale ("resale items"). The rule requiring resale goods to be accounted for as a separate inventory investment serves at least two important purposes. First, it prevents the distortion of income that results from commingling items having different cost characteristics (*i.e.*, resale items and manufactured items). Second, it prevents a manufacturer from substituting resale items for manufactured items whenever the manufacturer believes the NBU is experiencing a decrement. Thus, because resale items are not includible in NBU pools, a manufacturer is not required to include resale items within the scope of its LIFO election.

A manufacturer that wants to use the LIFO method for some (but not all) of the inventory investment of its NBU may elect to use multiple pools instead of a single NBU pool. Section 1.472-8(b)(3)(i)(*a*) provides that each pool of a manufacturer ordinarily shall consist of a group of items that are substantially similar. A manufacturer is given some latitude to determine which of its items are substantially similar, but must place its finished goods and work-in-process into pools classified by major classes or types of goods. *See* § 1.472-8(b)(3)(i)(*c*). In addition, a manufacturer may establish a miscellaneous pool for items that do not fall within its other pools, provided the value of these items is relatively insignificant compared to the value of the manufacturer's other inventory items. *See* § 1.472-8(b)(3)(i)(*d*). Similarly, because a reseller generally must assign items to pools by major lines, types, or classes of goods, the reseller may use the LIFO method for some (but not all) of its inventory investment. Section 1.472-8(c)(1) gives the reseller some latitude to consider customary business classifications of its particular trade (*e.g.*, a department in the case of a department store) when determining these groups.

Finally, in Rev. Rul. 76-282, the Service held that a taxpayer's right to select the class or classes of goods to be covered by the LIFO election goes to the nature of the goods themselves. Thus, when a taxpayer elects to use the LIFO method for a specific class of goods, the scope of the taxpayer's LIFO election must extend to all goods that fall within that class, including goods that are unsalable at normal prices or unusable in the normal way. Stated differently, the taxpayer must use the LIFO method to account for its entire investment in the specific class of goods. (Thus, the holding in Rev. Rul. 76-282 refutes the general principle Taxpayer inferred from the raw-material-content method.)

We believe that the inventory-investment concept applies to pools as well as to classes of goods. Thus, when a taxpayer elects to use the LIFO method for a specific class of goods and assigns that class of goods to a specific pool under its method of pooling, the scope of the taxpayer's LIFO election must extend to the taxpayer's entire investment in the class or classes of goods that fall within that pool. Stated differently, the taxpayer must use the LIFO method to account for its entire investment in the class or classes of goods that fall within its pool.

In conclusion, we believe that a taxpayer using the dollar-value LIFO method elects to use the method for a pool of items rather than for the individual items assigned to that pool. Thus, for the dollar-value LIFO method to clearly reflect income, the method must be used for all items that fall within a taxpayer's dollar-value pools. For taxpayers using IPIC-method pools, the 2-digit commodity codes in Table 6 of the PPI Detailed Report and the general expenditure categories of Table 3 of the CPI Detailed Report are analogous to "major lines, types, or classes of goods" under § 1.472-8(c)(1) and to "groups of inventory items which are substantially similar" under § 1.472-8(b)(3)(i)(*a*). Because Taxpayer excluded from the scope of its LIFO election some of the items that fall within its IPIC-method pools, Taxpayer's inventory method does not clearly reflect income. Thus, Exam may invoke § 1.472-3(c) to extend the scope of Taxpayer's LIFO election.

Issue 2: Should the national office revoke the letter ruling that permits Taxpayer's BBBB segment to use a non-LIFO method to account for some of the items that fall within its pools? If yes, is Taxpayer entitled under section 7805(b)(8) to have this revocation applied without retroactive effect?

Discussion:

We agree with Exam that the national office should revoke a letter ruling that permits Taxpayer's BBBB segment to use a non-LIFO method to account for some (but not all) of the items that fall within Taxpayer's IPIC-method pools. *See* section 11.02 of Rev. Proc. 97-27. But Taxpayer clearly disclosed on a separate schedule submitted with its Form 3115 that the proposed change in method will affect only items whose cost is 48.96 percent of Pool 4's inventory. Thus, because the letter ruling was issued in error, Taxpayer is entitled under section 7805(b)(8) to have the revocation of its letter ruling applied without retroactive effect. *See* section 15.06 of Rev. Proc. 2005-2. Accordingly, the national office hereby revokes Taxpayer's letter ruling effective for the first taxable year that begins after the date this TAM is issued to Taxpayer.

Issue 3: Should the national office revoke the automatic change in accounting method obtained by Taxpayer's ZZZZ segment under section 10.07 of the Appendix of Rev. Proc. 2002-9 and require Taxpayer's ZZZZ segment to revert to its former method of pooling? If yes, is Taxpayer's ZZZZ segment entitled under section 7805(b)(8) to have this revocation applied without retroactive effect?

Discussion:

We agree with Exam that the national office should revoke the automatic change in accounting method that permits Taxpayer's ZZZZ segment to use a non-LIFO method to account for some (but not all) of the items that fall within Taxpayer's IPIC-method pools. *See* section 9.03 of Rev. Proc. 2002-9. But because Taxpayer previously obtained the Commissioner's consent to terminate its LIFO election for some (but not all) of the items in Pool of 4 of the BBBB segment, Taxpayer had a reasonable basis to assume that changing to IPIC-method pools automatically without expanding the scope of its LIFO election is permissible. Furthermore, Taxpayer did not withhold material facts. Thus, Taxpayer is entitled under section 7805(b)(8) to have the revocation of its method change applied without retroactive effect. *See* section 15.06 of Rev. Proc. 2005-2. Accordingly, the national office hereby revokes Taxpayer's automatic change in accounting method effective for the first taxable year that begins after the date this TAM is issued to Taxpayer.

CAVEAT:

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