INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

October 03, 2006

Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-120787-06

Number: **200701031**
Release Date: 1/5/2007

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =

Date 1 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Year 7 =

ISSUE(S):

1. Whether a prior Technical Advice Memorandum (TAM) issued to Taxpayer, regarding its use of the index method and two indices to determine the last in, first-out (LIFO) value of dollar-value inventory pools, precludes the Service from requiring Taxpayer to change its LIFO inventory method and to take into account an adjustment under § 481(a) of the Code if Taxpayer's method of using two indices to value LIFO inventory increments does not clearly reflect income.

2. Whether the Service's prior-year audits of Taxpayer preclude the Service from requiring Taxpayer to change its LIFO inventory method and to take into account an appropriate adjustment under § 481(a) if Taxpayer's method does not clearly reflect income.

3. Whether the consent agreement between Taxpayer and the Service, permitting a change from the components-of-cost method to the product-cost method, precludes the Service from requiring Taxpayer to change its LIFO inventory method and to take into account an appropriate adjustment under § 481(a) if Taxpayer's method does not clearly reflect income .

4. Whether Taxpayer determined the index used to value increments in its dollar-value LIFO pools at earliest acquisition cost using the actual cost of the goods purchased or produced during the taxable year in the order of acquisition in accordance with § 1.472-8(e)(2)(ii)(b) of the Income Tax Regulations.

CONCLUSION(S):

1. Since TAM 7947001 makes no conclusions regarding the acceptability, accuracy, reliability, suitability or appropriateness of Taxpayer's use of two indices in its computation of the LIFO value of its dollar-value pools, the TAM does not preclude the Service from changing Taxpayer's LIFO inventory accounting method if Taxpayer's method of computing the LIFO value of its dollar-value pools does not clearly reflect income.

2. If Taxpayer's LIFO inventory method does not clearly reflect income (or is not in conformity with the LIFO inventory method regulations), the fact that Taxpayer was examined by the Service in prior years does not preclude the Service from requiring Taxpayer to change to a method of accounting that does clearly reflect income in the current year, nor does that fact act as a limitation on the computation of the appropriate adjustment under § 481(a).

3. The consent agreement permitting Taxpayer to change from the components-of-cost method to the product-cost method does not preclude the Service from requiring Taxpayer to change its method of determining the current-year cost and LIFO value of increments, nor does the consent agreement act as a limitation on the computation of the adjustment under § 481(a).

4. Taxpayer did not properly determine the index used to value increments using earliest acquisition cost in accordance with §1.472-8(e)(2)(ii)(b). However, if Taxpayer can demonstrate to the operating division director that its method does not distort income and results in an overall inventory value that is substantially the same as restating the ending inventory on an item-by-item basis at earliest acquisition cost, it may use its method.

FACTS:

Taxpayer is a domestic corporation and is engaged in the manufacture and sale of a number of different products. Taxpayer reports its income under an accrual method of accounting on the basis of a calendar year.

Taxpayer maintains its underlying books and records on a first-in, first-out (FIFO) basis. Taxpayer determines the cost of the inventory items produced each month based on the average cost of producing the inventory item for the month (average monthly cost basis); thus, all of the units of a particular item produced during a month have the same production cost. Taxpayer computes the current-year cost of its inventory based on the FIFO method, i.e., the cost of most recent production method.

For the tax year ending Date 1, Taxpayer filed a Form 970, Application To Use LIFO Inventory Method, in which it elected the dollar-value LIFO method of valuing inventory. Additionally, for the year ended Date 1, Taxpayer received permission from the Service to change from the use of material content pools to natural business unit pools.

Further, Taxpayer elected the “link chain” method for computing the base-year cost and LIFO value of its dollar-value inventory pools and the earliest acquisition method of costing goods in the ending inventory which are in excess of those in the beginning inventory. Taxpayer defined its dollar-value LIFO inventory items using the components-of-cost method.

Taxpayer noted in a statement attached to its Form 970 that in connection with its use of the link-chain method, it would use a sampling technique (index method) and two indices (dual index method) to compute the LIFO value of its dollar-value pools. One index (the deflator index) would be used to determine the base-year cost of ending inventory. The second index (the incremental index) would be used to determine the

LIFO value of the increment, if one was determined to exist. Taxpayer computed the deflator index, as follows: First, taxpayer determined the items constituting the largest seventy percent of the FIFO value, in dollars, in the pool at year-end (sample). Second, Taxpayer extended the quantity of each sample item in the pool at the close of the taxable year at current-year cost using FIFO, or the average monthly cost of most recent production and at prior-year cost using FIFO, or the average monthly cost of most recent production. Third, Taxpayer totaled the respective extensions at the two costs. These totals were used to develop a current-year index, which was then multiplied by the prior year's cumulative index to arrive at a current-year cumulative index. This current-year cumulative index was divided into the entire ending inventory value at FIFO (i.e., the average monthly cost of most recent production) to arrive at the aggregate base-year cost of the ending inventory. The base-year cost of the ending inventory was compared with the base-year cost of the beginning inventory. If there was an increment, an incremental index was calculated.

Taxpayer computed the incremental index, which it used to value increments, as follows: First, Taxpayer determined how quickly the particular pool inventory turned. Second, Taxpayer computed the average increment month cost for each sample item within the particular calendar month when the turn occurred (incremental month). Third, Taxpayer extended at average increment month cost and prior year cost at FIFO (i.e., the average monthly cost of most recent production), the quantity of each sample item in the pool at the close of the taxable year and totaled the respective extension at the two costs. The total current-year cost was divided by the total prior-year cost to derive the current-year index. The current-year index was then multiplied by the prior year's cumulative index to arrive at a current-year incremental index. The increment at base-year cost was multiplied by the current-year incremental index to determine the LIFO value of the increment.

In TAM 7947001, the national office addressed Taxpayer's method of computing the LIFO value of its dollar-value pools. Specifically, the national office considered the acceptability of Taxpayer's use of the dual index method in conjunction with a sampling technique (index method) to determine the LIFO value of its dollar-value pools. TAM 7947001 concluded that the index method does not prohibit the use of two indices but that the use of such indices must, in the opinion of the district director, be appropriate, accurate, reliable, and clearly reflect income under the circumstances. The TAM also concludes that in valuing an increment in dollar-value LIFO inventory at "earliest acquisition cost" under the index method, cost data for the period required to accumulate current-year cost for the entire ending inventory should be used.

For tax year Year 2, Taxpayer filed a Form 3115, Application for Change in Accounting Method, and received permission to change from the components-of-cost method to the product-cost method. The national office granted the change in method of accounting using a "cut-off" method, rather than with a § 481(a) adjustment. For a taxpayer using a LIFO inventory method, a change made using a cut-off method means that the taxpayer begins applying the new LIFO inventory method to the ending inventory for the year of change without also recomputing the beginning inventory using the new method of accounting. The consent agreement relating to the change provided that any issue pending concerning the components-of-cost method for any taxable years prior to Year 2, the year of change, was set aside by reason of Taxpayer making the change for Year 2.

In connection with the Commissioner's examination of Taxpayer's federal income tax returns for taxable years Year 3 through Year 4, the Commissioner proposed making two adjustments pertaining to the application of Taxpayer's LIFO method. The first adjustment pertained to Taxpayer's use of a dual index method for increment valuation (dual index issue). The second adjustment pertained to Taxpayer's use of representative sampling (segments of inventory sampling issue).

These issues were resolved pursuant to the Fast Track program. The Commissioner agreed, subject to examination or review of the matter in subsequent years, not to make an audit adjustment with respect to the dual index issue for the taxable years Year 3 through Year 4. However, the Commissioner reserved the right to propose appropriate adjustments (including adjustments under § 481(a) attributable to years from Year 1 forward) in later years, if the Commissioner, in one or more subsequent taxable years, determined Taxpayer's use of dual index method for increment valuation does not clearly reflect income. As to the segments of inventory sampling issue, the parties agreed to resolve the issue without requiring Taxpayer to change its method of accounting.

For taxable year Year 7, Taxpayer requested and received permission to change from the dual index method to the single index method for purposes of computing the LIFO value of its dollar-value pools. Taxpayer also changed its inventory sampling method. Taxpayer was not entitled to audit protection as a result of these changes because there was an issue pending with respect to the accounting methods that were changed.

The Service has raised the dual index issue in connection with the examination of Taxpayer for tax years Year 5 through Year 6. The parties have asked for technical advice regarding the revenue agent's proposal to change Taxpayer's method of computing the LIFO value of its dollar-value inventory on the basis that Taxpayer's use of the dual index method for increment valuations did not result in the valuation of Taxpayer's increments at earliest acquisition cost as required by § 1.472-8(e)(2)(ii)(b) from tax years Year 1 to Year 6. For purposes of this technical advice memorandum, we will assume that the items selected to compute the indexes satisfy the requirements of § 1.472-8(e)(1).

APPLICABLE LAW:

Section 471 provides that whenever in the opinion of the Secretary 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 Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Section 472(a) provides, in essence, that a taxpayer may use the LIFO method in inventorying goods specified in an application to use such method filed at such time and in such manner as the Secretary may prescribe. Section 472(a) also provides that 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 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) provides that in inventorying goods under the LIFO method, the taxpayer shall inventory them at cost.

Section 1.472-8(a) provides, in part, 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 the 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 § 1.472-8(b) and (c). 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 the pool, except as provided in § 1.472-8(g)(3), with respect to any item in the pool. Liquidations and increments of items contained in the pool are reflected only in terms of a net liquidation or increment for 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.

The propriety of the methods used to compute the LIFO value of a dollar-value pool is governed by § 1.472-8(e). This section expressly authorizes three methods, relevant to the instant matter, of computing the LIFO value of a dollar-value inventory pool: the double-extension method, the index method, and the link chain method.

Section 1.472-8(e)(1) provides, in part, 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. Under the double-extension method, the quantity of each item in the inventory pool at the close of the taxable year is extended at both base-year unit cost and current-year unit cost. The respective extensions at the two costs are then each totaled. The first total gives the amount of the current inventory in terms of base-year cost and the second total gives the amount of such inventory in terms of current-year cost. The sum of all extended base-year costs is divided into the sum of all extended current-year costs to obtain a dollar-value index. The dollar-value index is used to value increments.

Section 1.472-8(e)(1) also provides, in part, that in certain circumstances a 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 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.

Section 1.472-8(e)(1) provides that the use of the 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.

Section 1.472-8(e)(2)(ii) provides that the total current-year cost of items making up a pool may be determined –

(a) By reference to the actual cost of the goods most recently purchased or produced;

(b) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

(c) 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

(d) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

Section 1.472-8(e)(2)(iv) discusses the procedures to determine whether there is an increment or liquidation in a pool for a particular taxable year and how to value such increment or liquidation. The section provides that to determine whether there is an increment or liquidation in a pool for a particular taxable year, the end of the year inventory of the pool expressed in terms of base-year cost is compared with the beginning of the year inventory of the pool expressed in terms of base-year cost. When the end of the year inventory of the pool is in excess of the beginning of the year inventory of the pool, an increment occurs in the pool for that year. If there is an increment for the taxable year, the ratio of the total current-year cost of the pool to the total base-year cost of the pool must be computed. This ratio or index (incremental valuation index) when multiplied by the amount of the increment measured in terms of base-year cost gives the LIFO value of such increment.

Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

ANALYSIS:

The examining agent has proposed to change Taxpayer's method of accounting to a single index method with a corresponding § 481(a) adjustment on the ground that Taxpayer's use of the dual index method does not result in the valuation of Taxpayer's LIFO inventory at earliest acquisition cost pursuant to § 1. 472-8(e)(2)(b). Because consideration of the issue of whether the Service may require a change in accounting method is moot if the Service is estopped, we consider first the merits of Taxpayer's arguments that the Service is estopped from requiring a change in Taxpayer's LIFO method.

However, we believe it is important to clarify at the outset what type of adjustment that the examining agent is proposing, the basis for the adjustment, and the way in which the adjustment is computed. Many of the arguments in this case have been framed and phrased in terms of "adjusting historic LIFO layers under § 481(a)" and "year-by-year determinations about the suitability, accuracy, and reliability of the LIFO computations." In particular, Taxpayer's arguments seem to suggest that § 481(a) adjustments with respect to accounting method changes for LIFO inventory are limited to the extent the Service either tacitly or expressly accepted a LIFO computation in a prior taxable year. This view is incorrect.

A § 481(a) adjustment is necessary to prevent duplications or omissions arising as a result of a change in accounting method. The § 481(a) adjustment is computed based on the duplications or omissions that will occur as a result of the application of the new method compared to the old method. The § 481(a) adjustment is necessary irrespective of whether the old method was permissible or impermissible. Moreover, the fact that the old method was a permissible method, or otherwise accepted or approved on examination, has no effect on the computation of the § 481(a) adjustment. In other words, the § 481(a) adjustment is not limited to adjustments necessary to correct for improprieties in the old method. Thus, if the examining agent in this case requires

Taxpayer to change its accounting method because it does not clearly reflect income, a § 481(a) adjustment is necessary and is computed based on the duplications or omissions that would occur as a result of the change in accounting method regardless of whether the old method actually clearly reflected Taxpayer's income in prior years or was accepted as a clear reflection of income in the prior years. By the same token, if the examining agent does not change Taxpayer's method of accounting, § 481(a) does not authorize an adjustment to Taxpayer's LIFO layers related to imperfections in the prior year's inventory or cost of goods sold computations.

The § 481(a) computation for an inventory accounting method change is done by first determining what the beginning inventory value would have been had the new method been used for all prior taxable years and comparing that to the beginning inventory value in the year of change; the difference is the amount that will be duplicated or omitted as a result of the change to the new method of accounting. For a LIFO method change, this methodology requires the taxpayer to redetermine whether and to what extent there would have been an increment in terms of base-year cost for each prior taxable year under the new LIFO method and to value the increment using the new LIFO method. A taxpayer that voluntarily requests to change from one LIFO method to another is ordinarily permitted to make the change using a cut-off method, rather than with a § 481(a) adjustment. See section 3.09 of Rev. Proc. 97-27, 1997-1 C.B. 680; Section 3.10 of Rev. Proc. 2002-9, 2002-1 C.B. 327. The cut-off provision found in Rev. Proc. 97-27 and Rev. Proc. 2002-9 is an inducement to encourage taxpayers to voluntarily change from improper accounting methods at the earliest time possible. It is not predicated upon, or inspired by, whether the method was tacitly or explicitly accepted by the Service in prior taxable years. LIFO method changes made upon examination are not subject to the cut-off method transition rule of Rev. Proc. 97-27 and Rev. Proc. 2002-9. See section 5.04(2) of Rev. Proc. 2002-18, 2002-1 C.B. 678.

In the instant case, the examining agent is proposing to require the taxpayer to change from its dual index method to the use of a single index. Thus, under the new method, increments would be valued by multiplying the increment at base-year cost by the deflator index. If Taxpayer had used the new method in all prior years, it would have computed the same increments in terms of base-year cost for the same taxable years as were computed under the old method. However, those increments would have been valued using the deflator index rather than Taxpayer's incremental index. Generally speaking, the LIFO value of the inventory, i.e., the LIFO value of each layer of increment, would increase under the new method. The difference between the LIFO value under the old and new method was included in cost of goods sold in the taxable years in which the old method was used. The difference will also be included, i.e., duplicated, in cost of goods sold under the new method when the inventory is sold. Thus, the difference must be taken into account as a § 481(a) adjustment.

1**. Whether a prior TAM issued to Taxpayer, regarding its use of the index method and two indices to determine the LIFO value of dollar-value inventory pools, precludes the Service from requiring Taxpayer to change its LIFO inventory method and to take into account an appropriate adjustment under § 481(a) if Taxpayer's method of using two indices to value LIFO inventory increments does not clearly reflect income.**

In TAM 7947001, the national office addressed the issue of acceptability of Taxpayer's use of the index method along with two indices: one index, to determine if there has been a quantity increase in inventories and another index, the incremental index, to compute a LIFO value for the increment, if any. The TAM described the issue as follows:

> In this case the taxpayer is using one index to restate end of the year inventory to base-year cost using end of the year cost for 'current-year cost' in order to determine the quantity of inventory to be restated to base-year cost; in addition, a second index is used to value this increase (if any) in inventory quantity using earliest acquisition cost. . . . [T]he issue presented, however, is whether the use of an index is acceptable in order to restate end of the year cost to earliest acquisition cost.

In addressing the issue, the national office pointed out that §1.472-8(e)(1) is the basic provision outlining the use of the index method of pricing LIFO inventories. The national office noted the following:

> Among other things, this section states that 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 return.

The national office also discussed the regulatory standards for using the index method. In this regard, the national office stated:

> Under the 'index method' described in section 1.472-8(e)(1) of the regulations 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 (emphasis added). 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. Critical to the valuation of inventory

> under the 'index method' is the valuation of end of the year inventory at current cost and base-year cost.

In the TAM, the national office did not address whether Taxpayer qualifies to use the index method or whether the method actually used by Taxpayer clearly reflects income. As to the reliability and suitability of the index method actually used by Taxpayer, the national office stated:

> The facts do not indicate nor have you asked whether the taxpayer qualifies for the use of the index method and whether the index method clearly reflects income; this is a statistical determination that must be based on the facts and circumstances. However, the use of the index method requires that the sample selected must be representative of the items in the pool and the resulting price index must be appropriate for the pool.

The national office also did not determine if Taxpayer's use of two indices is acceptable or in compliance with the regulations. The national office stated:

> The use of an index to restate current-year cost to an earliest acquisition cost is a statistical device that must be considered and reviewed on a case-by-case basis. The use of such statistical device is not acceptable unless the overall inventory value is the same as restating the ending inventory on an item-by-item basis at earliest acquisition cost. While we are not opposed, per se, to the use of this type of index, such index must satisfy the clear reflection of income doctrine. Under sections 1.472-8(d) and 1.472-8(e)(1) of the regulations, the appropriateness of the method of computing an index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director. Clearly, if the use of an index to restate current-year cost to an earliest acquisition cost distorts income then the taxpayer must be required to value ending inventory on an item-by-item basis at earliest acquisition cost; such a change would constitute a change in method of accounting under section 446(e) of the Code to which section 481 would be applicable.

The national office did point out that §1.472-8(e)(2) requires that increments measured in terms of base-year cost be multiplied by an incremental valuation index (ratio of the total current-year cost of the pool to the total base-year cost of the pool) to arrive at the LIFO value of such increments. As to the appropriate method of computing an incremental index under the index method in general and Taxpayer's index method specifically, the national office stated:

> [T]he index method requires only that a representative portion of the ending inventory be double-extended. It is our conclusion, therefore, that an increment in inventory under the index method must be valued by multiplying the base year cost of the increment by an index (the incremental valuation index) determined with reference to the current year cost of the ending inventory. The index would give effect to the taxpayer's election to value the increment using earliest acquisition cost for current year cost. Since the index would be determined using cost data for the entire ending inventory, we conclude that when valuing an increment at earliest acquisition cost, cost data for the period required to accumulate the entire ending inventory should be used.

In sum, TAM 7947001 only sets forth the conditions, standards, and requirements Taxpayer must satisfy for its method of using two indices and the index method to compute the LIFO value of its dollar-value pools at earliest acquisition cost to clearly reflect income. The national office made no determinations regarding the acceptability, accuracy, reliability, suitability or appropriateness of Taxpayer's use of two indices to compute the LIFO value of its dollar-value pools. Therefore, TAM 7947001 does not preclude the Service from requiring Taxpayer to change its LIFO inventory method and to take into account an appropriate adjustment under § 481(a) if Taxpayer's method does not clearly reflect income.

2. Whether the Service's prior-year audits of Taxpayer preclude the Service from requiring Taxpayer to change its LIFO inventory method and to take into account an appropriate adjustment under § 481(a) if Taxpayer's method does not clearly reflect income.

Sections 446, 471,and 472 give the Commissioner wide latitude in determining whether a taxpayer's method of accounting for inventory clearly reflects income. If a taxpayer's method does not clearly reflect income, these provisions authorize the Commissioner to require the taxpayer to change to a method of accounting that does clearly reflect income. However, the Commissioner may not require a taxpayer to change from a method of accounting that clearly reflects income.

Whenever the Commissioner requires a taxpayer to change its method of accounting, § 481(a) authorizes the Commissioner to make an adjustment to the taxpayer's taxable income to avoid omissions or duplications occurring solely by reason of an accounting method change. The adjustment is equal to the cumulative difference between the taxable income computed under Taxpayer's accounting method and the taxable income computed under an accounting method which the Commissioner believes clearly reflects income. Section 481(a) permits the Commissioner to take into account amounts attributable to taxable years with respect to which assessment is barred by the statute of limitations. Graff Chevrolet Co. v. Campbell, 343 F.2d. 568, 572 (5^{th} Cir. 1965); Hamilton Industries v. Commissioner, 97 T.C. 120 (1991). As explained above, the amount of the adjustments under § 481(a) are not limited based on the propriety or acceptance of the old method of accounting.

Taxpayer contends that its use of LIFO, including its use of the dual index method and sampling, has been the subject of regular reviews by revenue agents and by the national office in connection with applications for accounting method changes. Citing Klein Chocolate Co. v. Commissioner, 36 T.C. 142 (1961), Taxpayer argues that the Service, through its actions over the years, has accepted its method of computing the LIFO value of inventory pools, and therefore, adjustments to its LIFO method are precluded. According to Taxpayer, the Service has never objected to its method of computing the LIFO value of pools even though the Service has been aware of and given consideration to Taxpayer's LIFO method, including its use of the dual index method and sampling, since its initial adoption and has examined several times the manner in which Taxpayer computes its LIFO inventory.

As to the Service's failure to make adjustments to Taxpayer's method of computing the LIFO value of its dollar-value pools in prior-year audits, it has long been recognized that the Commissioner is not bound by prior accounting methods merely because the tax returns have been examined and no deficiency has been asserted. H.E. Boecking, Jr. v. Commissioner, T.C. Memo. 1993-497; Fruehauf Corp. v. Commissioner, 356 F.2d. 975 (6th Cir. 1966). Similarly, to promote uniform application of the tax law, "the Commissioner must follow authoritative sources of Federal tax law and may correct mistakes of law made by IRS agents or employees." Deal v. Commissioner, T.C. Memo. 1999-352 (citing Dixon v. United States, 381 U.S. 68, 72 (1965); Massaglia v. Commissioner, 286 F.2d 258, 262 (10th Cir. 1961, aff'g, 33 T.C. 379 (1959). In Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957), the U.S. Supreme Court held that the Commissioner is empowered retroactively to correct mistakes of law in the application of the tax laws to particular transactions.

Therefore, the Service is not estopped from requiring Taxpayer to change its LIFO inventory accounting method if Taxpayer's LIFO method is not in conformity with the LIFO inventory regulations or if otherwise necessary to clearly reflect income. Likewise, the Service is not estopped from making appropriate adjustments under § 481(a) and corresponding adjustments to Taxpayer's LIFO layers if Taxpayer's LIFO method is not in conformity with the LIFO inventory regulations or if adjustments are otherwise necessary to clearly reflect income.

Furthermore, we believe Taxpayer's reliance on Klein Chocolate in misplaced. In Klein Chocolate, the taxpayer in 1942 elected to value its inventory using the dollar-value LIFO inventory method and a single pool. The taxpayer consistently adhered to that method for pricing its inventories beginning with tax year 1942 and through tax years 1946 and 1947.

In 1946, the Service examined and accepted the single pool for tax years 1942, 1943, and 1944. However, in a subsequent audit of the 1946 and 1947 returns, the Service accepted taxpayer's use of the dollar-value method of pricing its inventories but determined that the taxpayer had erred in its use of a single pool for its inventories instead of 10 separate pools.

The Tax Court reasoned that the Commissioner's determination was more an expression of preference for the use of 10 pools over the single pool consistently used and approved by the Commissioner than a determination that taxpayer's consistent use of a single pool will not reasonably reflect income. Therefore, the Tax Court concluded that the Commissioner was in error in determining deficiencies through the use of multiple pools. In so concluding, the Tax Court noted that the taxpayer's use of the single pool had been approved by the Service as proper and as clearly reflecting income and had consistently been used by the taxpayer in the pricing of goods for inventory purposes.

In the instant case, the revenue agent's proposed adjustment is not based on the Service's preference for one dollar-value pricing method that clearly reflects income over another dollar-value pricing method that clearly reflects income as was the case in Klein Chocolate. Rather, the revenue agent's bases for adjustment are that Taxpayer's method does not comply with the regulations and does not clearly reflect income. Thus, the instant case is factually distinguishable from Klein Chocolate and Klein Chocolate does not preclude the Service from making an inventory accounting method change on such bases.

Even if the Service approved an erroneous method, Klein Chocolate cannot be used as a shield to preclude a correction. Klein Chocolate does not bar the Service from changing an erroneous method of accounting which the Service approved and that would allow a taxpayer to continue to distort income in a future year. 36. T.C. at 147. See also Thomas v. Commissioner, 92 T.C. 206 (1989) ("to hold that respondent is prohibited from requiring a taxpayer to change from an erroneous approved accounting method to an accounting method which clearly reflects income would defeat the purpose and importance of the statutes' requirement, in section 446(b), that the method of accounting 'clearly reflect income'") and Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957) (the Commissioner is empowered retroactively to correct mistakes of law in the application of the tax laws to particular transactions).

3. Whether the consent agreement between Taxpayer and the Service, permitting a change from the components-of-cost method to the product-cost method, precludes the Service from requiring Taxpayer to change its LIFO inventory method and to take into account an appropriate adjustment under § 481(a) if Taxpayer's method does not clearly reflect income.

Taxpayer argues that the Year 2 consent agreement it entered into with the Service approved its methods of accounting for LIFO inventory, including the use of the dual index method and sampling. The consent agreement allowed Taxpayer to change its accounting method from a components-of-cost method to the product-cost method on a cut-off basis. Therefore, Taxpayer contends that the consent agreement resolved the LIFO issues and precludes any change to its LIFO inventory methods and adjustment to its LIFO layers for any tax years prior to the tax year of change under the agreement. We disagree.

A taxpayer's dollar-value LIFO method is comprised of a number of accounting methods, often referred to as LIFO sub-methods. These methods include the taxpayer's method of defining dollar-value LIFO items, inventory pooling method, index computation method, method of determining base-year cost, and method of determining current-year cost. The components-of-cost method and the product-cost method are methods of defining items in a dollar-value pool.

The components-of-cost method was the subject of the consent agreement. Further, the terms and conditions of the consent agreement only limited adjustments with respect to the components-of cost issue for taxable years prior to the year of change to the product-cost method. In this regard, the consent agreement provided that "any issue now pending before the Internal Revenue Service for any taxable years ended prior to the year of change concerning the method of accounting that is the subject of this letter shall be set aside by reason of the taxpayer making the change for the year of change."

The language in the consent agreement addressing Taxpayer's LIFO method provides as follows:

> 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 those relative to the use, accuracy, or reliability of the link-chain method, remain subject to determination by the District Director in connection with the examination of the consolidated income tax returns.

Indeed, it follows from the language noted that the parties to the consent agreement contemplated further and future Service review of Taxpayer's other LIFO sub-methods and appropriate changes of any impermissible method used to compute the LIFO value of inventory. Therefore, the consent agreement does not preclude an accounting method change, including a 481(a) adjustment, relating to Taxpayer's use of the dual method to value LIFO inventory increments.

4. Whether Taxpayer determined the incremental index used to value increments in its dollar-value LIFO pools at earliest acquisition cost using the

actual cost of the goods purchased or produced during the taxable year in the order of acquisition in accordance with § 1.472-8(e)(2)(ii)(b).

The examining agent has raised an issue regarding the propriety of Taxpayer's use of the dual index method to value inventory increments, if any, at earliest acquisition cost. The examining agent has not raised the issue of whether the use of the dual index method is impermissible per se. Nor has the examining agent asked us to revoke TAM 7947001, which was issued to Taxpayer and which indicates that a dual index method based on a sample may clearly reflect income under certain circumstances and is not per se impermissible. Rather, the scope of the examining agent's inquiry concerns the question of whether Taxpayer's use of the dual index method to compute the incremental index clearly reflects income and results in the valuation of increments at earliest acquisition cost pursuant to § 1.472-8(e)(2)(ii)(b). Accordingly, for purposes of discussing the incremental index, we will assume that Taxpayer's use of both a deflator index and the incremental index computed under Taxpayer's methodology, results in an inventory valuation not materially different than that which would result if a single overall index were used.

Taxpayers who elect to use the dollar-value LIFO method agree to follow the computational requirements of §1.472-8(e) to ensure the proper valuation of their dollar-value pools and to clearly reflect income. Section 1.472-8(e)(2) provides rules for determining the total current-year cost of ending inventory and an index to value LIFO increments, if any, under the double-extension method. It has been assumed that these rules are also applicable, with some modifications, to the link-chain method, used in conjunction with the index method or with a sampling technique. Under the double-extension method, each item in the ending inventory for each of a taxpayer's pools is extended at its current-year cost and at its base-year cost. Under the link-chain method, however, the current-year cost and the preceding year's cost of each item in the ending inventory are compared and used to compute a current-year index for each year. Each year's current-year index is multiplied or linked to all preceding year's current-year indexes to arrive at a cumulative index that relates back to the taxpayer's base year. Further in this regard, the index method requires only that a representative portion of ending inventory be double-extended instead of the entire ending inventory.

Section 1.472-8(e)(2)(iv) provides that if there is an increment for the taxable year, the ratio of the total current-year cost of the pool to the total base-year cost of the pool must be computed. This ratio (index) when multiplied by the amount of the increment measured in terms of base-year cost gives the LIFO value of such increment. It follows therefrom that an increment in inventory under the double-extension, link-chain, and index methods must be valued by an index (incremental valuation index) determined with reference to the current-year cost of the ending inventory.

Section 1.472-8 prescribes several methods for computing the current-year cost of items making up a pool. One of the methods prescribed for determining the current-year cost of items making up a pool is the earliest acquisition cost method. Under the earliest acquisition cost method, the total current-year cost of items making up a pool is determined by reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition. Section 1.472-8(e)(2)(ii) also provides that taxpayers may compute current-year cost pursuant to any proper method, which in the opinion of the Commissioner, clearly reflects income.

Section 1.472-8(d) provides, in relevant part, that the propriety of all computations incidental to the use of pools will be determined in connection with the examination of the taxpayer's income tax return. This section also provides that adequate records must be maintained to support the base-year unit cost as well as the current-year unit cost for all items priced on the dollar-value LIFO inventory method. Similarly, §1.472-8(e)(1) provides that adequate records must be maintained by the taxpayer to support the appropriateness, accuracy, and reliability of an index or link-chain method.

Taxpayer elected the link-chain method of pricing LIFO inventories and the earliest acquisition cost method of determining the current-year cost to value inventory increments. Under Taxpayer's method, if there was an increment, Taxpayer determined the first turnover period and the particular calendar month when the turn occurred (increment month). Taxpayer extended the end of the year quantity of the sample items used to compute the deflator index, at their average cost for the increment month and prior-year cost to determine the current-year incremental index at earliest acquisition cost that was used to determine the current-year cumulative incremental index at earliest acquisition cost.

Taxpayer's method assumed that the average cost within the increment month for each item making up its year-end inventory pool is the actual earliest acquisition cost of such item from the beginning of the year to a period sufficient to cover the quantity of such item in ending inventory and used to develop the incremental valuation index. Additionally, Taxpayer's method assumed that its inventory mix was constant throughout the year. Taxpayer's assumptions may not have been supported by the facts and its method may not necessarily replicate earliest acquisition cost.

Since Taxpayer elected to value inventory increments at earliest acquisition costs, it was necessary for Taxpayer to use as current-year cost, for purposes of computing the incremental index at earliest acquisition cost, the actual cost of the goods purchased or produced during the taxable year in the order of acquisition as required by § 1.472-8(e)(2)(ii)(b). Taxpayer did not value its inventory properly under the link-chain method using earliest acquisition cost as required by §1.472-8(e)(2)(ii)(b).

TAM 7947001, which, as noted, was issued to Taxpayer and upon which Taxpayer can rely, states that Taxpayer's use of its dual index method "is not acceptable unless the overall inventory value is the same as restating the ending inventory on an item-by-item basis at earliest acquisition cost." (Emphasis added.) Thus, if Taxpayer can demonstrate to the operating division director that its method does not distort income and results in an overall inventory value that is substantially the same as restating the ending inventory on an item-by-item basis at earliest acquisition cost, it may use its method. Accordingly, we believe the burden is on Taxpayer to demonstrate to the operating division director that its use of the dual index method is acceptable and results in an overall inventory value that is substantially the same as restating the ending inventory on an item-by-item basis at earliest acquisition cost as prescribed in TAM 7947001.

An index computed using a sample ordinarily will not yield the exact same ending inventory value as a determination of current-year cost on an item-by-item basis of the entire inventory, but, if the sample is appropriate under §1.472-8(e), will yield an ending inventory value that is substantially similar to the value that would have been computed on an item-by-item basis of the entire inventory. As stated above, we have assumed that the items selected to compute the indexes satisfy the requirements of § 1.472-8(e)(1). Thus, in this case, if Taxpayer had determined the actual earliest acquisitions cost of the items in the sample using the costs for the period necessary to accumulate the ending inventory quantity of those items, Taxpayer's method would satisfy the substantially similar standard we believe must by applied to this case, given TAM 7947001 and the assumption that the sample is appropriate under §1.472-8(e). Therefore, we believe that in this case, the examining agent, in evaluating Taxpayer's dual index method should consider all of the facts and circumstances, particularly whether the current-year cost used to compute the inflator index derived from applying Taxpayer's method of determining the cost of the sample is substantially the same as the current-year cost of the sample determined by reference to the earliest acquisitions during the year, using cost data for the period required to accumulate the ending inventory.

In accordance with TAM 7947001, which the examining agent has not requested that we revoke, if the use of an index distorts income, then the Taxpayer must be required to value ending inventory on an item-by-item basis at earliest acquisition cost provided adequate records have been maintained to permit a computation using earliest acquisitions cost. This change or any other appropriate change in Taxpayer's method of determining current-year cost would constitute a change in method of accounting under § 446(e) to which § 481 would be applicable.

CAVEAT(S):

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